U.S. Congress. House.

Prevention of tax avoidance

Washington

1933

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73d Congress }
2d Session }

HOUSE COMMITTEE PRINT

PREVENTION OF TAX AVOIDANCE

PRELIMINARY REPORT OF A SUBCOMMITTEE

OF THE

COMMITTEE ON WAYS AND MEANS

RELATIVE TO

METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF

Printed for the use of the Committee on Ways and Means

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1933

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LETTER OF TRANSMITTAL

WASHINGTON, *December 4, 1933.*

Hon. ROBERT L. DOUGHTON,
Chairman Committee on Ways and Means,
House of Representatives, Washington, D.C.

MY DEAR MR. CHAIRMAN: Pursuant to House Resolution 183, passed June 9, 1933, you appointed this subcommittee to investigate methods of preventing the evasion and avoidance of the internal revenue laws, to consider means of improving and simplifying such laws, and to study possible new sources of revenue.

In view of the fact that a new revenue bill is contemplated during the coming session of the Congress, it is thought imperative to transmit to the Ways and Means Committee a preliminary report recommending methods of preventing tax evasion and avoidance, together with certain suggestions for improving and simplifying the revenue laws. Such a report is transmitted herewith.

A report on new sources of revenue and a complete report on simplification are contemplated by the subcommittee, but cannot be transmitted at this time as the investigation of these matters is not concluded.

The preliminary report submitted herewith is divided into two parts: Part I, containing what may be considered as covering the major problems; and Part II, containing what may be considered as covering the minor problems. These problems in both parts are taken up in the general order in which they will occur in the revenue bill.

The subcommittee have given attention to these matters nearly continuously except for the months of August and September. In connection with their investigations they have had full cooperation from representatives of the Treasury Department, of the legislative counsel's office of the House, and of the staff of the Joint Committee on Internal Revenue Taxation. It is hoped that the preliminary report will be useful to the Committee on Ways and Means in considering pending revenue legislation.

Respectfully submitted.

SAMUEL B. HILL,
Chairman.

PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE

FOREWORD

This preliminary report has been prepared by the subcommittee of the Committee on Ways and Means, appointed, as a result of House Resolution 183, to investigate (1) tax avoidance, (2) simplification of the revenue laws, and (3) possible new sources of revenue. The report now submitted is confined to the first two named subjects, namely, tax avoidance and simplification, and has for its immediate purpose the presentation of recommendations or suggestions for legislation which will prevent such tax avoidance or which will simplify the existing revenue laws.

It has been considered desirable to divide the report into two parts so that the major problems may be discussed first. This arrangement prevents duplication in the discussion, as some of the minor problems must be answered consistently in view of the recommendations in the case of the major problems.

A tentative committee print of the Revenue Act of 1932 is submitted with this report showing all the changes recommended in that act by your subcommittee, which it has been possible to draft in the time available. The few changes not drafted will be submitted in such form at an early date.

PART I. MAJOR PROBLEMS

(1) Tax-Rate Structure

(*a*) *Normal tax.*—Section 11 of the Revenue Act of 1932 provides for a normal tax equal to 4 percent of the first $4,000 of the net income in excess of the credits provided in section 25, plus 8 percent of the balance over $4,000.

Your subcommittee recommends the use of one normal rate of 4 percent and the adjustment of the surtax rates so that the tax burden on incomes other than dividends and partially tax-exempt interest will remain practically unchanged. The principal advantages of this change are (1) simplification; (2) increased tax on dividends; and (3) increased tax on partially tax-exempt interest.

Our first revenue acts provided for one normal rate and graduated surtax rates. There appears to be no good reason for having both a graduated normal tax and a graduated surtax, since the principle of ability to pay can be adequately taken care of by the graduated surtax alone. Certainly, it is much simpler to have one normal rate of tax. How the change can be made without appreciably decreasing the revenue through adjustment of surtax rates will be explained later.

It is believed that dividends may be properly subjected to a somewhat greater income tax. Under the Revenue Act of 1932 a single man with a net income from dividends of $50,000 pays a tax of $4,960, while a single man with a net income from salary of $50,000 pays a tax of $8,720. In such a case the man with dividend income, under the recommendation of your subcommittee, will pay a tax of $6,900. In other words, instead of paying $3,760 less tax than the salaried man he will pay only $1,820 less tax. This is due to the fact that dividends are now subject to an 8-percent exemption from income tax, while under the proposal they will only be subject to a 4-percent exemption. It is the opinion of your subcommittee that this increased tax on dividends can well be borne.

In the case of partially tax-exempt income a similar result is obtained from the single 4-percent normal rate, since this income is also exempt from normal tax. Your subcommittee deliberated at length in regard to the question of making all tax-exempt income taxable but came to the conclusion that the only proper way to handle the subject in its broad aspect was through an amendment to the Constitution. However, it believes that the higher tax resulting from the use of one 4-percent rate is justifiable. This higher tax will apply only to obligations of the United States issued after September 1, 1917, which are not wholly tax exempt. In exhibit A of the appendix to this report a memorandum from the staff of the Joint Committee on Internal Revenue Taxation will be found which treats at length of the subject of wholly and partially tax-exempt interest.

(*b*) *Surtax.*—Section 12 of the Revenue Act of 1932 provides for surtax rates starting at 1 percent on net incomes of more than $6,000 and reaching 55 percent on net incomes of more than $1,000,000. Fifty-three different rate brackets are provided for in this act.

In view of the change recommended in the normal rates, your subcommittee recommends changes in these surtax rates to maintain the same tax on ordinary income as at present, and your subcommittee deems it wise to recommend further the reduction in the number of surtax brackets from 53 to 27 for the purpose of simplification.

A comparison of the present and proposed surtax rates follows, the much simpler form of the latter being obvious without argument:

Present surtax rates

	Percent		Percent
$6,000–$10,000	1	$46,000–$48,000	21
$10,000–$12,000	2	$48,000–$50,000	22
$12,000–$14,000	3	$50,000–$52,000	23
$14,000–$16,000	4	$52,000–$54,000	24
$16,000–$18,000	5	$54,000–$56,000	25
$18,000–$20,000	6	$56,000–$58,000	26
$20,000–$22,000	8	$58,000–$60,000	27
$22,000–$24,000	9	$60,000–$62,000	28
$24,000–$26,000	10	$62,000–$64,000	29
$26,000–$28,000	11	$64,000–$66,000	30
$28,000–$30,000	12	$66,000–$68,000	31
$30,000–$32,000	13	$68,000–$70,000	32
$32,000–$36,000	15	$70,000–$72,000	33
$36,000–$38,000	16	$72,000–$74,000	34
$38,000–$40,000	17	$74,000–$76,000	35
$40,000–$42,000	18	$76,000–$78,000	36
$42,000–$44,000	19	$78,000–$80,000	37
$44,000–$46,000	20	$80,000–$82,000	38

Present surtax rates—Continued

	Percent		Percent
$82,000–$84,000	39	$100,000–$150,000	48
$84,000–$86,000	40	$150,000–$200,000	49
$86,000–$88,000	41	$200,000–$300,000	50
$88,000–$90,000	42	$300,000–$400,000	51
$90,000–$92,000	43	$400,000–$500,000	52
$92,000–$94,000	44	$500,000–$750,000	53
$94,000–$96,000	45	$750,000–$1,000,000	54
$96,000–$98,000	46	Over $1,000,000	55
$98,000–$100,000	47		

Proposed surtax rates

	Percent		Percent
$4,000–$6,000	4	$62,000–$68,000	35
$6,000–$8,000	5	$68,000–$74,000	38
$8,000–$10,000	6	$74,000–$80,000	41
$10,000–$14,000	8	$80,000–$90,000	45
$14,000–$18,000	10	$90,000–$100,000	50
$18,000–$22,000	12	$100,000–$150,000	52
$22,000–$26,000	14	$150,000–$200,000	53
$26,000–$30,000	16	$200,000–$300,000	54
$30,000–$34,000	18	$300,000–$400,000	55
$34,000–$38,000	20	$400,000–$500,000	56
$38,000–$44,000	23	$500,000–$750,000	57
$44,000–$50,000	26	$750,000–$1,000,000	58
$50,000–$56,000	29	Over $1,000,000	59
$56,000–$62,000	32		

(*c*) *Credits against net income.*—Under section 25 of the Revenue Act of 1932, there are allowed as credits against net income for normal tax (but not for surtax) purposes, dividends, interest on obligations of the United States, personal exemptions, and credits for dependents.

To carry out the policy of retaining practically the same tax burden on ordinary income, it is necessary in connection with the proposed plan to allow the personal exemptions and credits for dependents as an offset against surtax as well as normal tax. Moreover, in accordance with the principle of ability to pay, there seems to be no good reason why these credits should not be allowed for the computation of both taxes. Under present law, for instance, a single man with an income of $7,000 from dividends pays exactly the same tax as a married man with 10 children having the same income from dividends. The personal exemptions and credits for dependents would appear to be in lieu of deductions for necessary living expenses. They should obviously apply to both taxes as do all other ordinary deductions.

(*d*) *Effect of rate structure changes.*—The changes recommended in paragraphs (*a*), (*b*), and (*c*), above, are interrelated, and it is now necessary to point out the combined result of these changes. The exact results are shown in four tables, which will be found in exhibit B of the appendix, showing the present and proposed taxes on various amounts and kinds of net income in the case of both single and married persons.

An examination of these four tables is sufficient to determine the following facts in relation to the effect of the changes proposed in the rate structure of existing law:

First. The tax on income from salaries, business, wholly taxable interest, rents, royalties, etc., is not changed to a consequential amount in any case. There is absolutely no change on net incomes of $6,000 or less. Above $6,000 there is a slight increase on the single man and a slight decrease on the married man. These slight changes seem proper. Under existing law a married man in this class pays a tax of $30,100 on an income of $100,000 while a single man on the same income pays $30,220. This slight difference in tax of $120 is obviously insufficient in view of the difference in ability to pay of the two persons. Under the proposed rates these two individuals will pay taxes of $29,810 and $30,620, respectively.

Second. The tax on income derived from dividends and partially tax-exempt Government obligations will be substantially increased as a result of the proposed changes, although such tax will still be substantially lower than the tax on earned income. For instance, at present the married man's tax on an earned income of $100,000 is $30,100; and on income from dividends of like amount $22,460. Under the proposed rates the tax in the latter case will be $25,910 instead of $22,460. It is believed this increase can well be borne both in the case of dividend income and in the case of income from partially tax-exempt interest.

The subcommittee is of the opinion that these changes in the rate structure will increase the revenues of the Government by approximately $36,000,000 annually.

(2) Depreciation and Depletion

Your subcommittee has been impressed by the extent to which taxable net income is reduced by the deductions for depreciation and depletion, allowed under sections 23 (k) and (l) of the Revenue Act of 1932.

While recognizing the soundness from an accounting standpoint of these deductions, your subcommittee recommends that, for the years 1934, 1935, and 1936 these allowances be reduced by 25 percent.

In the first place, it must be remembered that these amounts deducted from income do not represent cash outgo like wages, repairs, and similar expenses, but are annual reserves generally theoretically set aside to replace plant and property investments. In the second place, the magnitude of such allowances depends on the life of the property—a very uncertain factor. The following figures show the depreciation and depletion deductions shown on corporation returns for 1930 and the net income and deficits thereon both before and after these allowances:

Corporations reporting net income

Net income before depreciation and depletion		$9,295,599,253
Depreciation	$2,622,845,724	
Depletion	243,940,819	
		2,866,786,543
Taxable net income		6,428,812,710

Corporations reporting deficit

Deficit before depreciation and depletion		$3,295,259,728
Depreciation	$1,363,363,159	
Depletion	219,074,967	
		1,582,338,126
Deficit after depreciation and depletion		4,877,594,854

Thus, in the case of profitable companies, net income is reduced 31 percent by these allowances, while in the case of unprofitable companies the deficits are increased by 48 percent. These percentages will be much greater in the depression years 1931 and 1932. It should also be mentioned that the depreciation allowance is more important from a revenue standpoint, as it is nearly 10 times greater than the depletion allowance. Moreover, depreciation has been increasing for years, while recently depletion has been decreasing.

Your subcommittee first investigated means of limiting the amount allowed to a certain percentage of net income, but this was found almost impossible to draft into law and was coupled with certain inequities. In the face of the present emergency, and because taxable net income is being completely wiped out by these allowances in many cases, your subcommittee has come to the conclusion that it will be wise to reduce the allowances made under existing law by 25 percent for the three years 1934, 1935, and 1936. This will furnish a fair trial of the limitation and will furnish temporary stability of revenue at least. On the other hand, no permanent injustice will be done individuals or corporations, as the basis of the depreciable or depletable property will only be reduced by the amount of these items allowable after the 25 percent reduction.

It is estimated that the adoption of this plan will result in an increase in revenue of about $85,000,000 for each of the three years mentioned.

(3) Capital Gains and Losses

Existing law provides in section 101 for a special treatment of the gains and losses resulting from the sale of capital assets held over 2 years. The tax on gains on such sales is limited to 12½ percent, with a corresponding limitation in case of losses. In the case of assets held less than 2 years, the gains are taxed in full and the losses allowed in full except in the case of stocks and bonds, losses from which are limited under section 23(r).

Our present system has the following defects:

First. It produces an unstable revenue—large receipts in prosperous years, low receipts in depression years.

Second. In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.

Third. Taxpayers take their losses within the 2-year period and get full benefit therefrom, and delay taking gains until the 2-year period has expired, thereby reducing their taxes.

Fourth. The relief afforded in the case of transactions of more than 2 years is inequitable. It gives relief only to the larger taxpayers with net incomes of over $16,000.

Fifth. In some instances, normal business transactions are still prevented on account of the tax.

Your subcommittee has examined the British system, which disregards these gains and losses for income-tax purposes. The stability of the British revenue over the last 11 years is in marked contrast to the instability of our own. In that period the maximum British revenue was only 35 percent above the minimum, while in our own case the percentage of variation was 280 percent.

Your subcommittee, however, has been unable to reach the conclusion that we should adopt the British system. It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed. Your subcommittee recommends the following plan submitted by the staff of the Joint Committee on Internal Revenue Taxation:

First. To measure the gain or loss from the sale of property by an individual according to the length of time he has held the property, the following percentages of gain or loss are recognized for tax purposes:

100 percent if the capital asset has been held for not more than 1 year;

80 percent if the capital asset has been held for more than 1 year but not more than 2 years;

60 percent if the capital asset has been held for more than 2 years but not more than 3 years;

40 percent if the capital asset has been held for more than 3 years but not more than 5 years.

20 percent if the capital asset has been held more than 5 years.

Second. In the cases where the losses as computed above exceed the gains so computed, the excess losses are entirely disallowed.

Third. In the case of corporations the graduated percentage reduction of gains and losses does not apply. However, capital losses sustained by corporations are allowed only to the extent of capital gains. Under the present law corporations are allowed to offset capital losses against ordinary income.

Fourth. The plan outlined above is not made applicable, for obvious reasons, to stock in trade or property which is included in the taxpayer's inventory.

It is believed that the adoption of this plan will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will give a revenue of perhaps $30,000,000 additional under present conditions without any substantial loss over a long period of years.

The whole subject is described in greater detail in exhibit C of the appendix. In any event, the method proposed is absolutely safe from a revenue standpoint, inasmuch as capital losses cannot be used to reduce ordinary income, while gains are taxed in full or in part in proportion to the time for which the property has been held.

(4) Personal Holding Companies

Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the "incorporated pocketbook." That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.

For instance, suppose a man has $1,000,000 annual income from taxable bonds. His tax under existing law will be $571,100. However, if he forms a holding company to take title to the bonds and to receive the income therefrom, the only tax paid will be a corporate tax of $137,500 as long as there is no distribution of dividends. Thus, a tax saving of $433,600 has been effected.

It is true that section 104 of our income tax law puts a 50-percent penalty on this accumulation of profits to avoid surtaxes, but, nevertheless, there seems no doubt that this form of avoidance is still practiced to a large extent. By making partial distribution of profits and by showing some need for the accumulation of the remaining profits, the taxpayer is able to defeat the Government in proving a purpose to avoid surtaxes.

Your subcommittee, therefore, recommends that the present section 104 be divided into two parts, one dealing with the personal holding company and the other with all other corporations which accumulate unreasonable surpluses. The part dealing with personal holding companies has been entirely rewritten, while the present law has been retained with a few modifications to provide for the other companies.

In regard to the personal holding companies, your subcommittee recommends that they be defined as any corporation 80 percent of whose gross income for the taxable year is derived from rents, royalties, dividends, interest, annuities, and gains from the sale of securities, and whose voting stock to the extent of more than 50 percent is owned by not more than five individuals at the close of the taxable year. In computing the number of individuals who own the majority of the voting stock of a corporation it is proposed to count as one all members of a family in the direct line as well as the spouse and brothers and sisters.

It is recommended that a tax of 35 percent be levied on the "undistributed adjusted net income" of such corporations. This undistributed adjusted net income is determined by adding to the net income of a corporation the amount of dividends received from other corporations and the amount of partially tax-exempt interest and by subtracting therefrom Federal income taxes paid, contributions or gifts not otherwise allowed for income-tax purposes, and actual losses from the sales or exchanges of capital assets to the extent to which they are not otherwise allowed. From the result of this computation, which gives what is called the "adjusted net income", there is to be subtracted an arbitrary allowance of 10 percent of the adjusted net income and the dividends paid to stockholders during the taxable year. The purposes of the two last-named deductions are (1) to allow such corporations a reasonable reserve for contingencies and (2) to prevent the additional tax from applying to sums actually distributed.

The effect of this system recommended by your subcommittee is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose to avoid surtaxes. It is believed that the majority of these corporations are formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders.

In regard to the tax on other corporations which improperly accumulate surpluses for the avoidance of surtaxes, only two major

changes need be made. First, it is recommended that the rate of tax on these other corporations be reduced to 25 percent. The 50 percent rate now imposed is entirely too high to be readily enforceable. It represents a tax of much more than would have been imposed if the surplus had been distributed. Moreover, such surplus, even after the payment of tax, is still subject to the surtax in the hands of the individual when ultimately distributed. Second, the present law imposes the tax upon the entire net income; that is, the tax is the same whether 50 percent of the net income was distributed or whether none of it was distributed. It is, therefore, recommended that the tax be applied to the net income after the amount of such net income has been diminished by the amount of dividends paid during the taxable year.

Much more might be said in regard to corporations which are formed or availed of for the purpose of preventing the imposition of surtaxes upon the stockholders. Several instances have recently been developed in connection with the investigations of the Senate Committee on Banking and Currency, and, therefore, it is believed unnecessary to go into this matter further.

Your subcommittee believes that its recommendation now made in respect to these companies is of the utmost importance and, furthermore, that it will result, directly or indirectly, in increasing the annual revenue of the Government by not less than $25,000,000.

(5) Exchanges and Reorganizations

Your subcommittee makes the following recommendations with respect to exchanges and reorganizations:

(*a*) That the exchange and reorganization provisions contained in section 112 of existing law be abolished;

(*b*) That in cases where the immediate payment of the tax on a gain resulting from an exchange or reorganization results in undue hardship to the taxpayer, the Treasury be granted authority to extend the time for the payment of that portion of the tax attributable to such gain for a period not in excess of 2 years.

The elimination of the exchange and reorganization provisions will serve a twofold purpose. First, it will close the door to one of the most prevalent methods of tax avoidance. Second, it will greatly simplify the income tax law by eliminating some of its most complicated provisions. The underlying principle behind all of the exchange and reorganization provisions of the present law is that they do not result in tax exemption, but that the tax is postponed. It is claimed that many of the so-called exchanges or reorganizations result in mere paper profit, and that to tax them at the time of the exchange will seriously interfere with business. However, under the existing system the taxpayer is able to escape tax on these gains entirely by being permitted to elect the year in which he shall report such gain.

Many of the exchanges and reorganizations which the Supreme Court holds result in taxable income under the Revenue Act of 1917 and prior acts, are now made tax-free under the present law. Your subcommittee is of the opinion that any system is unsound which does not tax gains in the year in which realized. The year of realization is the year in which such gains become income under the Constitution, and to defer the taxing of gains until later years opens a wide field of tax avoidance.

For these and other reasons stated in the report of the staff of the joint committee contained in exhibit D of the appendix, your subcommittee is of the opinion that the exchange and reorganization provisions of the present law should not be retained. It is estimated that this change will result in a saving to the Government of at least $18,000,000 annually.

(6) Dividends out of Pre-March 1, 1913, Earnings

The present law, in section 115, provides that if a corporation pays a dividend out of earnings or profits accumulated before March 1, 1913, or out of increase in value of property accrued before March 1, 1913, the dividend in either case is not taxable to the stockholder.

Your subcommittee recommends that these dividends be subjected to the surtax in the hands of the stockholder as in the case of any other dividend received. Such action was recommended by the Committee on Ways and Means and approved by the House in connection with the Revenue Acts of 1928 and 1932, but the Senate rejected the proposed change. The subject, therefore, has been fully discussed in the past.

The present system is equivalent to allowing a large volume of dividends from the stock of domestic corporations to go entirely tax-free and to swell the already large total of tax-exempt income from Federal, State, and local obligations. It is believed that the recommendation of your subcommittee, if followed, will result in an increased annual revenue of approximately $6,000,000.

(7) Foreign Tax Credit

Your subcommittee recommends complete elimination of the provision of the present law (sec. 131, Revenue Act of 1932) allowing foreign income taxes to be credited against Federal income tax. The present provision discriminates in favor of American citizens and domestic corporations doing business abroad as compared with those doing business in this country. For instance, an American citizen who pays a State income tax is only entitled under the present law to deduct such tax from his gross income in arriving at his net income subject to the Federal tax. He is not permitted to offset his State income tax against his Federal income tax. However, if an American citizen pays an income tax to a foreign country, the present law allows him, under certain limitations, to reduce his Federal income tax by the amount of such foreign tax. Furthermore, a domestic corporation doing business in this country is also only allowed a deduction from gross income for the income taxes paid to the States. However, an American corporation doing business abroad, either directly or through a subsidiary company, is entitled, subject to certain limitations, to offset its Federal tax by the amount of income taxes paid to a foreign country. This discrimination is particularly noticeable in view of the recent decision of the Supreme Court holding that the term "foreign country" as used in the credit sections means not only a foreign state recognized in international law but any political subdivision thereof, no matter how small.

Under the Revenue Acts of 1913, 1916, and 1917, a taxpayer was not entitled to any credit for taxes paid to a foreign country. These early acts permitted taxes paid to a foreign country to be deducted only from gross income, which was also the rule applied in the case of State, county, and municipal taxes.

Your subcommittee is of the opinion that taxes paid to foreign countries should be treated in the same manner as taxes paid to the States and should only be allowed as a deduction from gross income. It is estimated that the elimination of the foreign-tax credit will increase the Government revenues by about $10,000,000 annually.

(8) Consolidated Returns

Section 141 of existing law permits corporations, which are affiliated through 95 percent stock ownership, to file consolidated returns.

Your subcommittee recommends that this permission be withdrawn.

The subject of consolidated returns has long been in controversy. The revenue bill of 1918, as passed by the House, prohibited the consolidated return which had been previously allowed under the regulations of the Treasury Department. The bill as passed by the Senate and finally enacted specifically provided for the consolidated return. The revenue bill of 1928, as passed by the House, denied the right to file consolidated returns, but this provision was eliminated in the Senate. During the consideration of the revenue bill of 1932 a compromise was effected resulting in the levying of an additional tax of three fourths of 1 percent on the consolidated net income. This additional tax was increased to 1 percent by the National Industrial Recovery Act.

It cannot be denied that the privilege of filing consolidated returns is of substantial benefit to the large groups of corporations in existence in this country. This is especially true in depression years, for the effect of the consolidated return is to allow the loss of one corporation to reduce the net income and tax of another, and during a depression more losses occur. Another effect of the consolidated return is to postpone tax. This is because there is no profit recognized for tax purposes on intercompany transactions, and profits on a product of the consolidated group, passing through the hands of the different members of the group, are not taxed until the product is disposed of to persons outside the group.

In the past, when any corporation could carry forward a net loss from one year to another, the consolidated group did not have such a great advantage over the separate corporation. Now that this net-loss carry-over has been denied, the advantage of the consolidated return is much greater on a comparative basis.

Your subcommittee is of the opinion that, at least in the first few years, an annual increase in revenue of $20,000,000 will result from the proposed elimination of the consolidated return.

(9) Partnership Losses

Under the present law (sec. 182, Revenue Act of 1932) as interpreted by the Treasury, a member of a partnership is entitled to reduce his ordinary income by a net loss of the partnership of which he is a member, according to his distributive share in the partnership. For instance, an individual might have an income of $100,000 from sources outside the partnership. If he has a one-half interest in a partnership which has a net loss of $100,000, he is able to reduce his taxable income by 50 percent. Your subcommittee is of the opinion that partners should not be permitted to offset against their ordinary income, losses sustained by the partnership. It is estimated that this change will increase the revenue by at least $7,000,000 annually.

(10) Problems Passed Over

(*a*) *Earned income.*—The Revenue Acts of 1924, 1926, and 1928 all gave a credit for earned income. This relief was continued in the revenue bill of 1932 as passed by the House, although the tax credit was changed to a deduction in the interest of simplification. The relief was finally eliminated in the Senate solely because of the necessity for more revenue. Your subcommittee has examined this question and believes some moderate form of earned income relief justifiable. The principle of taxing earned income at somewhat lower rates than investment income is recognized by practically all other nations having an income tax. However, while recognizing the equity of this principle, your subcommittee has refrained from making a recommendation thereon until the revenue requirements of the Government are made known.

(*b*) *Officers' salaries.*—Your subcommittee debated at length the advisability of limiting the amount of the deduction allowed to a corporation on account of salary or other compensation received by any officer of the corporation. The numerous examples of excessive officers' salaries brought to light during the past year were not overlooked.

It appears that, while some desirable purpose might be accomplished from the limitation mentioned, no gain in revenue could be expected. On the contrary, if lower officers' salaries were actually paid, a loss in revenue would result. This comes about because high salaries bear not only the normal tax but heavy surtaxes, while distributions in dividends would bear no normal tax and on account of the spread of the amount distributed among all the stockholders would bear less surtax in the aggregate.

In view of the above, your subcommittee refrains from making a recommendation on this subject.

(*c*) *Community property income.*—The income-tax situation existing in eight States of the Union having community property laws has been carefully considered. No recommendation in regard thereto is made by your subcommittee in view of the legal difficulties involved.

(*d*) *Intoxicating liquors.*—Considerable attention has been given to the question of liquor taxes, but in view of the fact that the President has created an interdepartmental committee to study the questions involved, it was the thought of the subcommittee that further consideration should be deferred until recommendations were received from the President. It is the thought of the subcommittee, however, that in the event additional legislation is required, the same should be handled by separate legislation and not made a part of the general revenue bill, in order to expedite its passage so as to protect the Treasury from loss of revenue.

(*e*) *Future issues of United States obligations.*—Your subcommittee is generally favorable to the policy of making all future issues of Federal Government obligations subject to surtax. However, no recommendation is made thereon in the absence of definite recommendations from the Treasury Department on this important matter connected with the fiscal policy of the Government.

(*f*) *Equitable provision.*—Due to the effect of the statute of limitations, it quite frequently happens that the same item of income is taxed twice or not at all. This comes about through the inclusion of such item in the return for the wrong year. In the same way it happens that deductions from income may be allowed twice or not at all.

Your subcommittee is of the opinion that these inequities should be cured, so that the Government might at least get the tax once on an item of income and not be obliged to allow a deduction twice. It is also deemed equally desirable that a taxpayer should not be taxed twice on the same item of income and allowed a proper deduction from net income once.

The subcommittee will endeavor to submit a recommendation on this important problem at a later date if certain practical difficulties can be overcome.

PART II. MINOR PROBLEMS

(1) Annuities

Section 22(b)(2) of the Revenue Act of 1932 provides for taxing annuities, but not until the total amounts received exceed the total amount paid for the annuity.

Your subcommittee is of the opinion that the tax on annuity receipts to the extent that they represent income should not be postponed as permitted by present law. Such receipts are, as a matter of fact, part interest and part return of capital. Therefore, it is recommended that some amount representing the portion of the annuity receipts consisting of interest be made subject to the income tax. In order to facilitate administration, it is recommended that an arbitrary rule be adopted that 3 percent of the amount paid for the annuity shall be deemed to be interest. This rule is applied only to annuity contracts.

(2) Interest on Money Borrowed to Purchase Tax-Exempt Securities

Section 23(b) of the Revenue Act of 1932 prohibits the deduction of interest on indebtedness incurred or continued to purchase or carry tax-exempt securities.

It appears that under the present wording of the law deposits in banks are not treated as indebtedness incurred to purchase such securities. Therefore, a taxpayer carrying on the banking business may deduct all the interest paid on deposits even though such deposits are invested in tax-exempt securities. Your subcommittee believes that interest paid on deposits invested in tax-exempt securities should be disallowed as a deduction for income-tax purposes. A change in the wording of this section is, therefore, recommended to accomplish this result.

(3) Deduction of Death and Gift Taxes from Net Income

Section 23(c) of existing law allows a deduction for estate, inheritance, legacy, succession, and gift taxes in computing net income subject to income tax.

These taxes constitute expenses or charges which are not incurred in the production of income, and liability for them attaches regardless of whether there is any income. They are, in fact, mere charges imposed upon the transfer of capital. Your subcommittee, therefore, recommends that such deductions be disallowed for income-tax purposes.

(4) Gambling Losses

Section 23 of existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under

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the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. Your subcommittee recommends a similar limitation on losses from legalized gambling. Under the present practice, many taxpayers take deductions for gambling losses but fail to report gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses.

(5) Future Expenses in Case of Casual Sales of Real Property

Under section 23 (o) of the Revenue Act of 1932, if an individual makes a casual sale of real property, he is permitted to reduce the gain from such sale by expenditures which he has contracted to make but which cannot be determined until later years. Your subcommittee recommends that this provision be eliminated as surplusage.

(6) Dividends from Foreign Corporations

Section 23 (p) (2) and section 25 (a) (2) treat dividends from a foreign corporation in the same manner as dividends from a domestic corporation, provided such foreign corporation receives more than 50 percent of its gross income from sources within the United States. Your subcommittee is of the opinion that all dividends received from foreign corporations should be treated alike, regardless of whether such foreign corporation has income from sources within the United States. Accordingly, it is recommended that section 23 (p) (2) and section 25 (a) (2) be eliminated. The effect of this recommendation will be (*a*) to deny a deduction to a domestic corporation for all dividends received from foreign corporations, and (*b*) to deny to any individual receiving such dividends the exemption from normal tax.

(7) Disallowance of Deductions Attributable to Tax-Exempt Income

It is proposed to add to section 24(a) of existing law a paragraph which will prevent the deduction of an item which is allocable to the production of income wholly exempt from the income tax.

For instance, interest on State securities, salaries received by State employees, and income from leases of State school lands are exempt from the Federal income tax. It is obviously improper to allow any deduction for expenses incurred in the production or acquirement of such income. Accordingly, your subcommittee recommends that a provision be inserted in the law specifically denying deductions allocable to such classes of income.

(8) Disallowance of Losses Between Members of Family

It is proposed to add to section 24(a) of existing law a paragraph which will deny losses to be taken in the case of sales or exchanges of property between members of a family, or between a shareholder and a corporation in which such shareholder owns a majority of the voting stock. The term "family" is defined to include brothers and sisters, spouse, ancestors, and lineal descendants.

Many instances have been brought to light where transactions have taken place for the sole purpose of taking a loss for income-tax purposes. It is believed that the recommendation of the subcommittee, if followed, will effectually close this opportunity for tax avoidance.

(9) Accrued Income and Accrued Deductions of Decedent

Sections 42 and 43 of the Revenue Act of 1932 define the period in which items of income and of deduction shall be included.

Your subcommittee recommends adding to the first of these sections a provision requiring the income-tax return of a decedent to include amounts of income accrued up to the date of his death, regardless of the fact that he may have kept his books on the cash basis. In the case of the second of these sections, a provision should be added allowing deductions to be likewise accrued.

Since the courts have held that income accrued by a decedent prior to his death is not income to the estate, it follows that unless such income is taxable to the decedent it will escape income tax altogether. For the same reason, unless expenses which accrued prior to death are allowed to the decedent, they cannot be used. The recommendation made by the subcommitee remedies these defects.

(10) Casual Sales on Installment Basis

Section 44(b) of the Revenue Act of 1932 allows the use of the installment method of reporting income where the initial payments do not exceed 40 percent of the selling price. The limit under former acts was 25 percent.

Your subcommittee recommends that the percentage be changed to 30 percent, for it is believed that the present high limit results in an unreasonable postponement of tax in cases where such tax can well be paid.

(11) Allocation of Income

Section 45 of existing law gives authority to the Commissioner to allocate items of income or deductions between trades or businesses which are owned or controlled by the same interests, when necessary to prevent evasion of taxes.

Your subcommittee recommends two minor changes in this section: (1) the inclusion of the word "organizations," along with trades and businesses, and (2) the addition of the word "avoidance" along with evasion. These changes give the Commissioner somewhat greater latitude in applying this section.

(12) Income Tax Receipts

Section 56 (h) requires the collector to furnish the taxpayer with an income-tax receipt upon payment of his income tax. This section is cumbersome in language and has been rewritten for the purpose of uniformity and simplification. As rewritten, it corresponds to the more concise language used in connection with requiring receipts for gift and estate-tax payments.

(13) Sale of Mines and Oil or Gas Wells

Section 102 of existing law provides that in the case of the sale of mines and oil or gas wells where the principal value of the property has been demonstrated by prospecting or discovery work done by the taxpayer, the tax attributable to such sale shall not exceed 16 percent of the selling price.

This provision was inserted in the law apparently as a subsidy to encourage the development of new mines and oil wells. In the present state of overproduction there is no need to continue this subsidy, and your subcommittee recommends the elimination of the entire section.

(14) Basis for Gift in Case of Loss

Under section 113 (a) (2) of the present law, if a taxpayer acquires property by gift he is required to use as his basis the basis the property had in the hands of the donor. This section has been utilized to transfer losses from one person who has little income to another person with a large income. For instance, a taxpayer has property which cost him $100,000, but which is now practically worthless. If he sells the property himself, the loss on the sale will not do him any good, due to the fact that he has no income against which to offset it. He transfers such property by gift to a relative or close friend with a large income, and such relative or close friend makes the sale and reduces his income by a $100,000 loss. To prevent this, your subcommittee recommends that the donee be required to use as his basis for determining loss the cost to the donor or the market value of the property at the time of the gift, whichever is lower.

(15) Basis for Property Passing by Power of Appointment

The last sentence of section 113 (a) (4) of the Revenue Act of 1932 prescribes the basis for gain or loss in the case of property passing under a general power of appointment exercised without consideration by will or deed in contemplation of death. Property transferred in this manner is included in the decedent's gross estate for estate-tax purposes. The income tax law lays down a special rule for determining the basis for computing gain or loss upon the sale of such property.

Your subcommittee sees no reason for adopting a special rule for this type of property. If such property passes under a general power of appointment exercised by will, its basis for gain or loss should be the same as that prescribed in the case of other property passing by bequest, devise, or inheritance. On the other hand, if the property passes under a power of appointment executed by deed without consideration and in contemplation of death, it represents a gift and should be subject to the same basis rule which applies to other gifts in contemplation of death. It is believed that an amendment to existing law should be made to accomplish this result.

(16) Basis for Property Transmitted at Death

Under section 113 (a) (5) of the Revenue Act of 1932, the basis for determining gain or loss, for income-tax purposes, on the sale or other disposition of property transmitted at death, is, in the

following cases, the fair market value thereof at the time of the death of the decedent:

(1) Where personal property was acquired by specific bequest;

(2) Where real property was acquired by general or specific devise, or by intestacy;

(3) Where the property, real or personal, was acquired by the decedent's estate from the deceased.

In all other cases, if the property was acquired by will or intestacy, the basis is the fair market value of the property at the time of distribution to the taxpayer.

Included within the phrase " all other cases " is personal property acquired by general or residuary bequest. Thus, where a trustee acquires personal property by general bequest, the basis of the property, on a sale by him, is the value at the time of distribution to him. The basis to the executor, in all cases, is the value of the property at the date of the decedent's death.

Oftentimes, the executor and trustee under a will are one and the same person. Thus, in the case of a general bequest of personal property, he is in a position to make use of one basis of valuation or the other according to which will most benefit the estate. The trustee, of course, may use a later basis than the executor, and where it is desired to sell personal property subject to a trust during the period of administration, the executor-trustee may determine whether it would be most advantageous to sell as executor or as trustee. Where the personal property has increased in value in the hands of the executor, under a general bequest, the property may be distributed to the trustee, who may use the higher basis in computing gain or loss on the sale, thereby diminishing the taxable increment and greatly reducing or entirely avoiding the income tax.

Section 113(a)(5) of the Revenue Act of 1932 is a reenactment of a similar provision contained in the 1928 act. The change in the 1928 act was made because there was some doubt as to the meaning of the term " date of acquisition," which was the term used under the Revenue Act of 1926. Since the 1928 act was passed, the Supreme Court has defined " the date of acquisition " to mean the date of death in the case of all property passing by bequest, devise, and inheritance, whether real or personal. (*Brewster* v. *Gage*, 280 U.S. 327.) Your subcommittee recommends that section 113(a)(5) of the Revenue Act of 1932 be changed to conform to the language contained in the Revenue Act of 1926, so that a uniform basis rule may be required in the case of property passing at death, whether real or personal.

(17) Basis of Property for Loss (Acquisition Before March 1, 1913)

Under section 113(a)(13) of existing law, the basis for determining gain or loss in the case of property acquired prior to March 1, 1913, is its cost or fair market value as of that date, whichever is greater. This rule when applied to losses in some instances grants the taxpayer a loss when no loss has been actually sustained. For instance, suppose a taxpayer bought property for $20,000 prior to March 1, 1913, which was worth $75,000 on that date. If he sells such property in 1933 for $60,000, he is allowed a loss of $15,000,

although he has in fact made a gain of $40,000. Your subcommittee is of the opinion that no loss should be allowed in any case where the selling price exceeds the taxpayer's investment in the property.

(18) Distributions in Liquidation

Section 115 (c) of the Revenue Act of 1932 treats a liquidating dividend as a sale of stock. This rule has serious objections, as it permits wealthy stockholders to escape surtax upon corporate earnings or profits distributed in the form of liquidating dividends. For instance, a corporation may have a surplus of $1,000,000. If the surplus is distributed as an ordinary dividend, it is subject to the surtax rates in the hands of the shareholder. If it is distributed as a liquidating dividend, it is subject only to the flat capital gain rate of 12½ percent in the case the shareholder has held his stock for more than 2 years. In addition to permitting the wealthy shareholder to escape surtax, the present rule also discriminates against the small shareholder. If the corporation makes a distribution of surplus as an ordinary dividend, it is exempt from the normal tax. Accordingly, a small shareholder, not being in the surtax brackets, is materially affected by the form of the distribution. If the distribution is made in the form of a liquidating dividend, the exemption from normal tax does not apply. This does not seem fair when it is considered that liquidating dividends may represent earnings or profits which if distributed as an ordinary dividend would be exempt from normal tax. The present law thus makes the tax depend upon the form of the distribution. Your subcommittee recognizes that liquidating dividends do contain some of the elements of a sale in that the stockholder is relinquishing in whole or in part his investment in the corporation. On the other hand they also contain some of the elements of an ordinary dividend insofar as they represent a distribution of earnings or profits.

Your subcommittee is of the opinion that the fairest method of treating liquidating dividends is to combine both the sale feature and the dividend feature. It is accordingly recommended that a liquidating dividend be treated as a sale of the stock, with the provision that the amount of gain to a shareholder shall be taxed as an ordinary dividend to the extent that it represents a distribution of earnings or profits, and as a gain from sale of property to the extent that it does not represent such a distribution. This will prevent the large shareholder from escaping the surtax on the earnings of the corporation and will also relieve the small shareholder from payment of the normal tax on liquidating distributions out of earnings or profits.

(19) Interest Received by Nonresident Aliens

Section 119 (a) (1) of the present law defines the income upon which nonresident alien individuals and foreign corporations are required to pay a Federal income tax. The Board of Tax Appeals has construed the present law to exempt nonresident aliens and foreign corporations from Federal income tax on any interest paid by the United States, the territories, or the District of Columbia, on their obligations, tax refunds, or judgments. Obviously, Congress did not intend to make such income exempt from the Federal income tax. Accordingly, section 119 (a) (1) has been amended to make it clear that such interest is taxable.

(20) Unlimited Deduction for Charity

Section 120 of the Revenue Act of 1932 provides for the allowance of charitable contributions in full where for the preceding 10 years 90 percent of the taxpayer's net income has been distributed by such contributions.

Section 23 (n) imposes a 15-percent limitation on charitable contributions in the general case in respect to the amount allowable in respect to net income.

Your subcommittee is of the opinion that section 120 should be eliminated.

(21) Withholding—Tax-Free Covenant Bonds

Section 143 (a) provides for the withholding by a corporation or other obligor of an amount equal to 2 percent of the amount of interest paid on bonds or other obligations which contain a provision by which the obligor agrees to pay any portion of the tax imposed upon the obligee. The tax is not required to be withheld at the source where the obligee files with the obligor a statement that he is not taxable under the income tax on account of his income being less than the amount of his personal exemption. The bondholder is entitled to a credit against his tax where there has been withheld a tax at the source on his account.

Your subcommittee recommends that this system of withholding a tax on tax-free covenant bonds be entirely discontinued. The system originated in the 1913 act, where general withholding was employed to collect a large portion of the tax. The withholding policy has now been abandoned and the withholding on tax-free covenant bonds is an exception to the general rule. It is an administrative nuisance and requires the payment of many small refunds. Simplification and reduction in administrative expense can be secured by the elimination of this section. No loss in revenue will result from the change.

(22) Information Returns

Sections 148 and 149 of the Revenue Act of 1932 authorize the Commissioner to require returns or statements from corporations in respect to the dividends paid shareholders, and from brokers in respect to business transacted with customers.

In view of recent disclosures as to stock-exchange practices, it is recommended by your subcommittee that these sections should be amended to require every corporation to file information returns as to dividends paid to any one person in an amount in excess of $1,000 annually, and to require every exchange broker dealing in stocks, bonds, etc., to file statements showing the names, addresses, and gross business transacted with persons whose gross business exceeds $100,000 annually.

It is hoped that these information returns and statements will enable the Commissioner to prevent more effectively tax evasion. A penalty not to exceed $1,000 is recommended for failure to file the information returns described above.

(23) Annuities Acquired by Bequest

Section 162 (b) and (c) of existing laws deals with the net income of estates and trusts. It has been brought to the attention of your subcommittee that if a widow receives an annual income from a trust in lieu of dower, the trust may deduct the payments to her from its net income and the widow will pay no income tax on the payments received.

A similar situation has arisen in the case of annuities established by will. If the trustee is required to pay to the beneficiary a fixed sum each year, regardless of whether the trust has any income, all of the amounts received by the beneficiary are exempt from income tax, although in some years they are actually paid out of income.

Your subcommittee recommends curing these defects in a reasonable manner by providing that the income of the estate or trust may be reduced by income paid to the beneficiaries only if such amounts are includable in the income of such beneficiaries.

(24) Interest Paid or Accrued—Insurance Companies

Section 203 (a) (8) provides for the deduction of interest "paid or accrued" by life insurance companies. Insurance companies are on the cash receipts and disbursements basis and the Supreme Court has held that in such cases the word "accrued" means paid. Your subcommittee, therefore, recommends for the purpose of clarification that the words "or accrued" be eliminated from this section. The change will have no effect on the application of the deduction.

(25) Ninety-Day Letter—Petition to Board

Section 272 (a) of the Revenue Act of 1932 gives the taxpayer 60 days in which to appeal to the Board of Tax Appeals from a deficiency notice mailed to him by the Commissioner. A considerable number of such deficiency notices are mailed to prevent the running of the statute of limitation and are based on incomplete information. It is believed that if more time were allowed between the date of mailing of the notice and the date required for the filing of the taxpayer's petition a large number of deficiencies could be settled by conference between the representatives of the Commissioner and the taxpayer, without the necessity for a petition.

Your subcommittee, therefore recomends extending this period for filing a petition to 90 days. It is believed that such action will result in less delay in the collection of the tax and in relieving the Board calendar of numerous cases.

(26) Statute of Limitations—Assessments

Section 275 of the Revenue Act of 1932 provides that income taxes must be assessed within 2 years after the return was filed.

Your subcommittee is of the opinion that the 2-year period is too short and should be extended to 3 years. The longer period is not intended to create delay in tax collections, but to prevent the escape of taxes legally due, and to eliminate the necessity for ill-considered deficiency letters in difficult cases. The revenue should be increased by this change.

Subsection (c) of this section provides that if a corporation fails to file a return but each shareholder includes in his return his distributive share of the net income of the corporation, then the corporate tax may be assessed within 4 years after the last date on which the shareholder's return was filed. Under the general rule, if a corporation fails to file a return, the corporate tax may be assessed at any time. Your subcommittee sees no reason for making an exception to the general rule merely because some of the shareholders have included corporate income in their returns. It is accordingly recommended that subsection (c) be eliminated.

There has been considerable difficulty from an administrative standpoint in keeping a record of the date which starts the assessment period. Under the present law the tax must be assessed within a certain period after the return is filed. The statute prescribes a last date for filing both fiscal and calendar year returns. In many cases, returns are filed before the due date and for this reason it is very difficult to maintain a proper record. It is, therefore, recommended by your subcommittee that all returns filed before the last due date be deemed to have been filed on the last due date for assessment purposes.

(27) Understatement of Gross Income

Section 276 provides for the assessment of the tax without regard to the statute of limitations in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax.

Your subcommittee is of the opinion that the limitation period on assessments should also not apply to certain cases where the taxpayer has understated his gross income on his return by a large amount, even though fraud with intent to evade tax cannot be established. It is, therefore, recommended that the statute of limitations shall not apply where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized when a taxpayer is so negligent as to leave out items of such magnitude from his return.

(28) Statute of Limitations—Refunds

Section 322 of the Revenue Act of 1932 provides that no credit or refund shall be made after 2 years from the time the tax was paid.

Your subcommittee in view of the change recommended in paragraph (26) also recommends that this period be changed from 2 to 3 years. As a matter of fairness, the period in which the taxpayer may recover overpayments should be the same as the period for assessment by the Government.

However, your subcommittee believes that under existing law the taxpayer has a longer period than the Government, since the taxpayer's period starts with the payment of the tax while the Govern-

ment's period commences with the filing of the return. When a tax is paid in installments, the taxpayer now has 9 months longer than the Government to secure tax adjustments.

To correct this inequality, your subcommittee recommends that the statute of limitations on refunds shall run within 3 years from the time the return was filed or within 2 years from the time the tax was paid, whichever period expires the later.

(29) Claims for Credit

Your subcommittee recommends incorporation of H.R. 5904 into the proposed legislation. This will save the Government $15,000,000 by preventing the Commissioner from refunding certain income taxes which were due on the merits but for which the taxpayers are demanding refunds on technical grounds. This bill passed the House during the last session but was not acted upon by the Senate due to the short time before adjournment.

(30) Sales of Personalty by Distraint—Section 3192, Revised Statutes

Under the present law the collector can bid in at a distraint sale only personal property which is subject to tax such as oleomargine, tobacco, spirits, etc. He cannot buy for the United States a Liberty bond or a Treasury note offered at a distraint sale. If no bid was made, he would be compelled to readvertise and offer again for sale the security seized under distraint. If an entirely inadequate bid was made for such security, the collector would be compelled to accept it. To remedy this, your subcommittee recommends that the collector be given power to establish a minimum price for personal property offered by him for sale under the process of distraint (as it is with respect to realty, R.S. 3197), and to bid in the same for the United States.

(31) Effective Date of New Revenue Bill

The question of retroactivity of the proposed legislation was considered by your subcommittee. In many cases it is impossible to make the proposed changes retroactive on account of constitutional objections. Furthermore, some doubt exists as to the possibility of passing the bill by March 1, which certainly should be done if the changes are to be given effect in returns filed on March 15.

Therefore, the wording of the bill in section 1 will make the act applicable to any taxable year beginning after December 31, 1933.

Under prior laws, the policy was to divide fiscal years into two parts and tax each part under the different act applicable thereto. Your subcommittee recommends discontinuing this troublesome practice, since there are no substantial rate changes. This will make the administrative work of handling fiscal year returns easier, and will simplify the act by eliminating part of section 48 (a) and all of sections 105 and 132.

If the Committee on Ways and Means desires to make certain provisions retroactive, this can be done in each special case, provided there is no constitutional bar to such retroactivity.

(32) Items Passed Over

The following propositions have received favorable action by your subcommittee but will not be finally recommended in view of difficulties of working them out, until such difficulties can be overcome.

(*a*) Section 52: It is believed desirable to make the officers of a corporation subject to penalty for the failure of the corporation to make a return. It appears that some difficulty exists in holding such officers liable for penalties under existing law in such a case because the statute requires the corporation to make the return.

(*b*) Section 113: The present law does not specifically provide for any cost basis in the case of the sale of mining grants. The Treasury has ruled that in the case of mining grants the basis for computing gain or loss from such sales shall be the value at the date the minerals are discovered. Your subcommittee believes the present law should be clarified so that the basis in such cases should be the cost to the person securing the grant.

(*c*) Section 115: It was hoped to tax distributions in kind by corporations on a more equitable basis, but no plan has been devised which overcomes constitutional objections.

(*d*) Section 311 (d): This section deals with transferee proceedings. It has been contended that under existing law a transferee who pays all the tax may be without remedy to enforce contribution from the other transferees. Your subcommittee is sympathetic to remedying this situation if it can be done.

(*e*) Your subcommittee is in favor of allowing a tax exemption for estate-tax purposes where the property has already been taxed by the estate tax in the hands of a prior decedent within 5 years as is permitted by present law. Your subcommittee is not in favor of allowing this exemption the second time when the property passes from the second decedent to the third as is permitted by present law.

(*f*) Your subcommittee is of the opinion that a citizen of the United States should be subject to the estate tax on real property located abroad.

(*g*) Your subcommittee is of the opinion that all trusts which have not been subject to estate or gift taxes should be taxed on dissolution. The constitutional questions arising in this connection, however, are serious.

(*h*) Your subcommittee is of the opinion that suits against the collector for recovery of taxes should be abolished and that all such suits should be brought against the United States. At present either course can be pursued.

(*i*) Your subcommittee is of the opinion that where a circuit court of appeals refuses to hear a case on account of wrong jurisdiction, it should be allowed to determine the correct jurisdiction.

CONCLUSION

It is believed that the major changes proposed in part I of this report may result in additional revenue of about $235,000,000 per annum in a full year of operation, and that the minor changes proposed in part II may result in further revenue of $35,000,000—giving a grand total of $270,000,000. When business returns to normal, the additional revenue from these changes should be greater.

In any event, your subcommittee is of the opinion that if the changes proposed are adopted, the income-tax burden will be more fairly borne by all taxpayers with very few opportunities of escape therefrom by legal avoidance. The sooner all persons pay their full share of income taxes, the sooner some relief in the existing tax burden may be expected.

APPENDIX

Exhibit A

Memorandum on Wholly and Partially Tax-Exempt Interest

Much attention recently has been given to the question of whether the interest on Federal, State, and local bonds should be subject to taxation by the Federal and State Governments. A consideration of the facts in connection with the subject does not lead to an obvious conclusion. However, such facts as seem most important will be pointed out, and certain suggestions made in connection with the matter as appear to warrant consideration.

The total interest-bearing indebtedness of the Federal, State, and local Governments is estimated to be approximately $40,500,000,000 at this time. The annual interest charge on this amount is estimated to be approximately $1,805,000,000. The larger part of this latter sum is entirely free from Federal and State income taxes, although it is true that some of the Federal bonds are subject to surtaxes. Also, practically all of the bonds are subject to estate and inheritance taxes, and to the income tax insofar as a profit is realized upon the sale thereof.

Naturally we have accurate figures as to the total amount of Federal securities. On August 31, 1933, the total interest-bearing debt of the United States, outstanding, amounted to $22,722,597,530, of which amount $12,860,055,350 was subject to surtax, and $9,862,542,180 was wholly tax exempt as to both income and surtax. It appears that the average annual interest charge on this Federal debt will be approximately $825,000,000, indicating an average interest rate of approximately 3⅝ percent.

From incomplete data available, this office estimates the present State and local indebtedness to be about $17,800,000,000. The annual interest charge on this sum is probably not less than $980,000,000, indicating an average interest rate of 5½ percent.

Our revenue acts provide that taxpayers, both individual and corporate, shall report the interest received from these wholly or partially tax-exempt bonds. There is no penalty for not so reporting the wholly tax-exempt interest, and there might be some question as to the legality of such a penalty. In any event, it seems certain that a very considerable amount of the wholly tax-exempt interest is not reported on the returns. This, of course, makes no difference in our present revenue, but is disturbing when we make a statistical study of this question.

It has already been pointed out that our present annual interest charge on the total Federal, State, and local debt will amount to approximately $1,805,000,000. In 1930 this interest charge amounted to considerably less—probably to about $1,370,000,000. Nineteen hundred and thirty is the latest year on which we have complete income tax statistics, and in this year we can account for the following amounts of wholly or partially tax-exempt interest on the income-tax returns:

(1) Individuals with net income of $5,000 and over:	
Interest on State and local bonds	$172, 841, 118
Interest on wholly exempt United States bonds	51, 308, 177
Interest on partially exempt United States bonds (including farm loan bonds)	38, 133, 605
Subtotal	262, 282, 900
(2) Corporations—all:	
Interest on Federal, State, and municipal bonds	536, 260, 563
(3) Individuals with $5,000 gross but no net income:	
Interest on partially exempt Government bonds	5, 738, 139
Grand total	804, 281, 602

It is apparent, therefore, that the actual figures on the 1930 income-tax returns account for only $804,281,602 out of a total of probably $1,370,000,000 of wholly or partially tax-exempt interest paid out in that year. While we can account for some of this difference of $566,000,000 as going to the individuals with net incomes of less than $5,000, to tax-exempt corporations, and to foreign individuals and corporations, it must be admitted that the larger portion of the difference probably is the result of the tax-exempt interest not being reported on the returns. However, our figures seem sufficiently complete to form a basis for estimates.

Before speculating, however, as to how much revenue may be derived from the taxation of this interest, it will be necessary and interesting to observe the distribution of this kind of interest among our smaller taxpayers, our middle class, and our wealthy class. This distribution need be made only for individuals, since the corporate rate of tax is constant while the individual rates of tax are graduated. Furthermore, it can be computed from the figures already given that the corporations appear to hold about 67 percent of the total of Federal, State, and local obligations.

The wholly and partially tax-exempt interest reported by individuals with net incomes of over $5,000 has been computed for the years 1924, 1927, 1929, and 1930. This interest has been broken up into two groups: (1) United States securities and Federal farm loan bonds; and (2) State and local obligations. The interest derived from each of these groups has been further classified so as to show the amount received in each case by individuals with net incomes of over $5,000 and not over $25,000, by individuals with net incomes of over $25,000 but not over $100,000, and by individuals with net incomes of over $100,000. These facts are shown in the following four tables covering, respectively, the 4 years already named:

Wholly and partially tax-exempt interest reported by individuals with net incomes of over $5,000 by net income classes

Year	Net income class	United States securities and Federal farm loan bonds	Percent of total	State and local obligations	Percent of total	Total
1924	$5,000-$25,000	$41,530,723	65	$22,295,874	35	$63,826,597
	$25,000-$100,000	42,885,531	48	46,548,494	52	89,434,025
	Over $100,000	35,558,241	42	49,803,812	58	85,362,053
	Total	119,974,495	51	118,648,180	49	238,622,675
1927	$5,000-$25,000	39,417,257	57	30,036,240	43	69,453,497
	$25,000-$100,000	35,550,097	41	51,589,027	59	87,139,124
	Over $100,000	39,579,448	36	70,710,492	64	110,289,940
	Total	114,546,802	43	152,335,759	57	266,882,561
1929	$5,000-$25,000	32,222,421	53	29,018,872	47	61,241,293
	$25,000-$100,000	31,244,723	37	54,317,645	63	85,562,368
	Over $100,000	36,920,846	30	86,216,837	70	123,137,683
	Total	100,387,990	37	169,553,354	63	269,941,344
1930	$5,000-$25,000	33,133,796	46	38,589,450	54	71,723,246
	$25,000-$100,000	30,699,843	33	61,954,130	67	92,653,973
	Over $100,000	25,608,143	26	72,297,538	74	97,905,681
	Total	89,441,782	34	172,841,118	66	262,282,900

The following facts may readily be noted from the above tables:

First. The interest received, and hence the amount of Federal securities held, by all our individual taxpayers with net incomes of over $5,000 has steadily declined. In 1924 the interest received amounted to about 120 million; in 1927, to about 115 million; in 1929, to about 100 million; and in 1930, to about 89 million, a decline of 30 percent from 1924 to 1930.

Second. The interest received, and hence the amount of State and local obligations held, by all our individual taxpayers with net incomes of over $5,000 has somewhat increased. In 1924 the interest received amounted to about 119 million; in 1927, to about 152 million; in 1929, to about 170 million; and in 1930, to about 173 million; an increase of 45 percent from 1924 to 1930.

Third. The class of taxpayers with net incomes of from $5,000 to $25,000 do not find the Federal bonds unattractive. In 1924, 65 percent of their interest was received from such bonds and 35 percent from State and local bonds, while in 1930 the Federal interest received amounted to 46 percent and the State and local interest to 54 percent.

Fourth. In the case of the middle class of taxpayers with net incomes between $25,000 and $100,000, the proportion of Federal to State and local interest received is much less than in the smaller class and the shift to State and local investment greater. For instance, in 1924, of the total interest received by this class, 48 percent came from Federal securities and 52 percent from State and local obligations, while in 1930, 33 percent came from the former source and 67 percent from the latter.

Fifth. In the case of the wealthy taxpayers with net incomes of over $100,000, the unattractiveness of the Federal issues becomes even more pronounced and the shift to State and local issues still greater. In 1924 this class received 42 percent of their total interest from Federal securities and 58 percent from State and local obligations. In 1930, however, 26 percent came from Federal sources and 74 percent from State and local sources.

It is our conclusion from the above facts that the small taxpayer finds Federal bonds quite as attractive as State and local bonds, because the greater security offered by the former offsets the higher interest rate of the latter. In the case of the larger taxpayers, however, we are forced to the conclusion that State and local issues are preferred over Federal issues, not because this class of taxpayers desire less security, but because the State and local issues are entirely free from surtax while the majority of the Federal bonds are subject to such tax.

What additional revenue could be secured by subjecting all this interest on the public debt to tax? Based on the data available and the existing tax rates, we believe the maximum revenue which the Federal Government could obtain would not exceed $160,000,000 annually. Of this amount, about $90,000,000 would come from individuals and about $70,000,000 from corporations.

A study of the market quotations on Government bonds indicates that the wholly tax-exempt securities are slightly preferred over the partially exempt securities. This is true in spite of the fact that both classes of securities are wholly tax exempt when in the hands of corporations. Thus, a broad tax-free market is now open to corporations for the bonds which are only partially tax exempt in the hands of individuals. If this were not the case, authorities seem to agree that future bond issues by our governmental units would necessarily bear a higher interest rate.

An increase in interest rate of one fourth of 1 percent on $40,000,000,000 would cost our Government $100,000,000 annually; an increase of one half of 1 percent would cost $200,000,000 annually. Of course, the increase in interest costs would not take effect immediately if Congress taxed bonds already issued in tax-exempt form without retirement and reissue. However, to do so would raise a serious question of breach of faith and might be construed to violate the Constitution.

At the present time, substantial revenue could be secured by taxing the interest on all Federal, State, and local bonds if the income tax were applied to old as well as new issues. The question of whether such a procedure is right or wrong from a moral standpoint is one which is beyond the scope of this memorandum.

It is the opinion of this office that if the income tax were applied in full to all future issues of these bonds the increased interest cost would nearly offset the additional revenue secured.

SUGGESTIONS

If it is desired to subject all Federal, State, and local bonds to the income tax of both Federal and State Governments, it appears that the fairest way, and the only one free from legal uncertainties, would be to present the issue to the people through an amendment to the Constitution.

It is suggested that for present purposes it might be well for the Congress to consider the advisability of making all future issues of Federal interest-

bearing obligations subject to the surtax. This would restrict the opportunity now existing for the avoidance of this tax. In fact, much might be said, even in the case of a constitutional amendment, in favor of making the interest on Federal, State, and local bonds subject to surtaxes but not to normal taxes. It would have the effect of preventing tax avoidance without materially increasing the interest rate.

There is some possibility, in view of certain decisions of the Supreme Court of the United States, that even under existing law interest on governmental bonds can be reached by an excise tax in the case of individuals or corporations carrying on business. This question is discussed in the appended memorandum prepared by Mr. Stam, counsel to this committee.

As already stated, no obvious conclusion is apparent in connection with this matter. It is a subject of importance, and needs further investigation and study.

Respectfully,

L. H. Parker,
Chief of Staff.

POWER OF CONGRESS TO TAX TAX-EXEMPT SECURITIES

Many proposals have been submitted suggesting the taxation by the Federal Government of the income received from State and municipal securities. It is settled doctrine that without a constitutional amendment Congress has no power directly to tax the income received from State and municipal securities (*Metcalf and Eddy* v. *Mitchell, Admx.*, 269 U.S. 514, 521; *Pollock* v. *Farmers' Loan and Trust Company*, 157 U.S. 429; *National Life Insurance Co.* v. *U.S.*, 48 Sup. Ct. 593). However, there is a possibility that such income might be reached through an excise tax measured by the net income from all sources. In the case of corporations, it seems clear that this can be done. The corporation excise tax of 1909 taxed the privilege of carrying on or doing business by corporations. The tax was measured by the net income of the corporation from all sources. Since the subject of the tax was an exercise of a franchise or privilege, the Supreme Court held that Congress had the power to include in the measure of the tax the income from tax-exempt securities, although such income could not be directly taxed (*Stone Tracy Company* v. *Flint*, 220 U.S. 107). Moreover, some of the States through corporation excise taxes are now taxing the income from Federal securities by measuring the excise by the net income of the corporation from all sources. In at least two of the States, namely, California and New York, their power to do this has been upheld by the Supreme Court (*Pacific Company* v. *Johnson*, 285 U.S. 480; *Educational Films Company* v. *Ward*, 282 U.S. 379). In the California case, the Supreme Court made the following statement as to this point:

"The owner may enjoy his exempt property free of tax, but if he asks and receives from the State the benefit of the taxable privilege as the implement of that enjoyment, he must bear the burden of the tax which the State exacts as its price."

So far as individuals are concerned, there is a possibility that the income received by them from tax-exempt securities may also be reached through an excise. To do this, we must first find a taxable privilege upon which to base the excise. It seems clear that all trades, avocations and employments by which individuals acquire a livelihood may be made the subject of an excise or privilege tax. (See the Stone Tracy and Pollock cases, cited above.) Accordingly, if Congress levied an excise on individuals engaged in any business, occupation, trade, avocation, or employment, it seems entirely possible that such tax could be measured by the net income of the individual from all sources, including the income from tax-exempt securities. As stated by the Supreme Court in the Stone Tracy Co. case, "there is no rule which permits a court to say that the measure of a tax for the privilege of doing business, where income from property is the basis, must be limited to that derived from property used in the business." It is up to Congress to determine the measure of the excise and it seems entirely possible that the measure of such excise could be the net income of the individual from all sources, including tax-exempt securities.

Under this proposed scheme, there would be three taxes levied by the Congress: (1) An excise tax upon the carrying on or doing business by corporations, measured by the net income from all sources: (2) an excise tax upon individuals engaged in any trade, occupation, avocation, or employment, measured by the net income from all sources; and (3) a net income tax imposed upon all individuals and corporations not subject to the excise tax.

By this scheme, most of the income from tax-exempt securities could be reached. Those persons that would escape would be only those who do not engage in any trade, avocation, or employment, but merely hold securities. This scheme would also not extend to State employees engaged in governmental functions of the State, for such occupations being governmental in character could not be reached even through an excise.

Colin F. Stam, *Counsel.*

Exhibit B

Income tax on individuals—Present and proposed taxes

MARRIED PERSON WITH INCOME FROM SALARY, BUSINESS, OR WHOLLY TAXABLE INTEREST

Income	Present law	Proposed	Reduction	Increase
$1,000	$0	$0	----------	----------
$1,500	0	0	----------	----------
$2,000	0	0	----------	----------
$2,500	0	0	----------	----------
$3,000	20	20	----------	----------
$3,500	40	40	----------	----------
$4,000	60	60	----------	----------
$4,500	80	80	----------	----------
$5,000	100	100	----------	----------
$6,000	140	140	----------	----------
$7,000	210	200	$10	----------
$8,000	300	280	20	----------
$9,000	390	365	25	----------
$10,000	480	455	25	----------
$12,000	680	650	30	----------
$14,000	900	880	20	----------
$16,000	1,140	1,120	20	----------
$18,000	1,400	1,390	10	----------
$20,000	1,680	1,670	10	----------
$22,000	2,000	1,980	20	----------
$24,000	2,340	2,300	40	----------
$26,000	2,700	2,650	50	----------
$28,000	3,080	3,010	70	----------
$30,000	3,480	3,400	80	----------
$35,000	4,590	4,450	140	----------
$40,000	5,800	5,620	180	----------
$45,000	7,140	6,955	185	----------
$50,000	8,600	8,410	190	----------
$55,000	10,190	9,985	205	----------
$60,000	11,900	11,680	220	----------
$65,000	13,740	13,495	245	----------
$70,000	15,700	15,445	255	----------
$75,000	17,790	17,530	260	----------
$80,000	20,000	19,735	265	----------
$85,000	22,340	22,085	255	----------
$90,000	24,800	24,535	265	----------
$95,000	27,390	27,110	280	----------
$100,000	30,100	29,810	290	----------
$125,000	44,100	43,760	340	----------
$150,000	58,100	57,760	340	----------
$175,000	72,350	71,985	365	----------
$200,000	86,600	86,235	365	----------
$250,000	115,600	115,210	390	----------
$300,000	144,600	144,210	390	----------
$400,000	203,600	203,185	415	----------
$500,000	263,600	263,160	440	----------
$600,000	324,600	324,135	465	----------
$700,000	385,600	385,135	465	----------
$800,000	447,100	446,610	490	----------
$900,000	509,100	508,610	490	----------
$1,000,000	571,100	570,610	490	----------
$2,000,000	1,201,100	1,200,585	515	----------

Income tax on individuals—Present and proposed taxes—Continued

SINGLE PERSON WITH INCOME FROM SALARY, BUSINESS, OR WHOLLY FROM TAXABLE INTEREST

Income	Present law	Proposed	Reduction	Increase
$1,000	$0	$0		
$1,500	20	20		
$2,000	40	40		
$2,500	60	60		
$3,000	80	80		
$3,500	100	100		
$4,000	120	120		
$4,500	140	140		
$5,000	160	160		
$6,000	240	240		
$7,000	330	320	$10	
$8,000	420	410	10	
$9,000	510	500	10	
$10,000	600	600		
$12,000	800	820		$20
$14,000	1,020	1,060		40
$16,000	1,260	1,320		60
$18,000	1,520	1,600		80
$20,000	1,800	1,900		100
$22,000	2,120	2,220		100
$24,000	2,460	2,560		100
$26,000	2,820	2,920		100
$28,000	3,200	3,300		100
$30,000	3,600	3,700		100
$35,000	4,710	4,780		70
$40,000	5,920	6,010		90
$45,000	7,260	7,360		100
$50,000	8,720	8,860		140
$55,000	10,310	10,480		170
$60,000	12,020	12,220		200
$65,000	13,860	14,080		220
$70,000	15,820	16,060		240
$75,000	17,910	18,160		250
$80,000	20,120	20,410		290
$85,000	22,460	22,820		360
$90,000	24,920	25,270		350
$95,000	27,510	27,920		410
$100,000	30,220	30,620		400
$125,000	44,220	44,600		380
$150,000	58,220	58,600		380
$175,000	72,470	72,840		370
$200,000	86,720	87,090		370
$250,000	115,720	116,080		360
$300,000	144,720	145,080		360
$400,000	203,720	204,070		350
$500,000	263,720	264,060		340
$600,000	324,720	325,050		330
$700,000	385,720	386,050		330
$800,000	447,220	447,540		320
$900,000	509,220	509,540		320
$1,000,000	571,220	571,540		320
$2,000,000	1,201,220	1,201,530		310

MARRIED PERSONS WITH ALL INCOME FROM DIVIDENDS OR PARTIALLY TAX-EXEMPT BONDS

Income	Present law	Proposed	Reduction	Increase
$1,000	$0	$0		
$1,500	0	0		
$2,000	0	0		
$2,500	0	0		
$3,000	0	0		
$3,500	0	0		
$4,000	0	0		
$4,500	0	0		
$5,000	0	0		
$6,000	0	0		
$7,000	10	20		$10
$8,000	20	60		40
$9,000	30	105		75
$10,000	40	155		110
$12,000	80	270		190
$14,000	140	420		280
$16,000	220	580		365
$18,000	320	770		450
$20,000	440	970		530
$22,000	600	1,200		600
$24,000	780	1,440		660
$26,000	980	1,710		730
$28,000	1,200	1,990		790
$30,000	1,440	2,300		860
$35,000	2,150	3,150		1,000

Income tax on individuals—Present and proposed taxes—Continued

MARRIED PERSONS WITH ALL INCOME FROM DIVIDENDS OR PARTIALLY TAX-EXEMPT BONDS—Continued

Income	Present law	Proposed	Reduction	Increase
$40,000	$2,960	$4,120		$1,160
$45,000	3,900	5,255		1,355
$50,000	4,960	6,510		1,550
$55,000	6,150	7,885		1,735
$60,000	7,460	9,380		1,920
$65,000	8,900	10,995		2,095
$70,000	10,460	12,745		2,285
$75,000	12,150	14,630		2,480
$80,000	13,960	16,635		2,675
$85,000	15,900	18,785		2,885
$90,000	17,960	21,035		3,075
$95,000	20,150	23,410		3,260
$100,000	22,460	25,910		3,450
$125,000	34,460	38,860		4,400
$150,000	46,460	51,860		5,400
$175,000	58,710	65,085		6,375
$200,000	70,960	78,335		7,375
$250,000	95,960	105,310		9,350
$300,000	120,960	132,310		11,350
$400,000	171,960	187,285		15,325
$500,000	223,960	243,260		19,300
$600,000	276,960	300,235		23,275
$700,000	329,960	357,235		27,275
$800,000	383,460	414,710		31,250
$900,000	437,460	472,710		35,250
$1,000,000	491,460	530,710		39,250
$2,000,000	1,041,460	1,201,685		79,225

SINGLE PERSON WITH ALL INCOME FROM DIVIDENDS OR PARTIALLY TAX EXEMPT BONDS

Income	Present law	Proposed	Reduction	Increase
$1,000	$0	$0		
$1,500	0	0		
$2,000	0	0		
$2,500	0	0		
$3,000	0	0		
$3,500	0	0		
$4,000	0	0		
$4,500	0	0		
$5,000	0	0		
$6,000	0	40		$40
$7,000	10	80		70
$8,000	20	130		110
$9,000	30	180		150
$10,000	40	240		200
$12,000	80	380		300
$14,000	140	540		400
$16,000	220	720		500
$18,000	320	929		600
$20,000	440	1,140		700
$22,000	600	1,380		780
$24,000	780	1,640		860
$26,000	980	1,920		940
$28,000	1,200	2,220		1,020
$30,000	1,440	2,540		1,140
$35,000	2,150	3,420		1,270
$40,000	2,960	4,450		1,490
$45,000	3,900	5,600		1,700
$50,000	4,960	6,900		1,940
$55,000	6,150	8,320		2,170
$60,000	7,460	9,860		2,400
$65,000	8,900	11,520		2,620
$70,000	10,460	13,300		2,840
$75,000	12,150	15,200		3,050
$80,000	13,960	17,250		3,290
$85,000	15,900	19,460		3,560
$90,000	17,960	21,710		3,750
$95,000	20,150	24,160		4,010
$100,000	22,460	26,660		4,200
$125,000	34,460	39,640		5,180
$150,000	46,460	52,640		6,180
$175,000	58,710	65,880		7,170
$200,000	70,960	79,130		8,170
$250,000	95,960	106,120		10,160
$300,000	120,960	133,120		12,160
$400,000	171,960	188,110		16,150
$500,000	223,960	244,100		20,140
$600,000	276,960	301,090		24,130
$700,000	329,960	358,090		28,130
$800,000	383,460	415,580		32,120
$900,000	437,460	473,580		36,120
$1,000,000	491,460	531,580		40,120
$2,000,000	1,041,460	1,121,570		80,110

Exhibit C

Memorandum on Capital Gains and Losses

The wisdom of including in taxable income gains from the sale of real estate, stocks, bonds, and other assets of a capital nature has long been a subject of controversy. A like question arises as to the wisdom of permitting losses from such sales to be deducted from income.

Speaking generally, we have always taken account of gains and losses from capital transactions in the computation of net income, while Great Britain has pursued the opposite policy and disregarded such gains and losses in determining net income.

Two reports have been made by the staff of the joint committee on this subject. A summary of the first report will be found on pages 40 to 48 of the Report of the Joint Committee on Internal Revenue Taxation, dated November 15, 1927. The second report is entitled "Supplemental Report on Capital Gains and Losses", and was published under date of June 9, 1929. The data contained in these reports cannot be repeated here for lack of space, but will be relied on to a considerable extent in advancing certain suggestions in connection with the matter.

The great advantage of the English system lies in the stability which it gives to the income-tax revenue. The stability of their revenues and the instability of our own can be readily seen from the following comparison of Federal and British income-tax receipts:

Fiscal year	United States (millions of dollars)	Great Britain (millions of dollars[1])	Fiscal year	United States (millions of dollars)	Great Britain (millions of dollars [1])
1923	1,691	1,936	1931	1,860	1,583
1924	2,842	1,724	1932	1,057	1,782
1925	1,761	1,746	1933	747	1,528
1926	1,974	1,652			
1927	2,220	1,482	Total, 11 years	21,068	17,833
1928	2,175	1,521	Average annual revenue	1,915	1,621
1929	2,331	1,436			
1930	2,410	1,443			

[1] Converted to dollars at the rate of $4.86 per pound sterling.

While the above figures show on their face the instability of our income-tax revenues and the stability of the British revenues from the same source, it may be interesting to analyze the results in terms of percentages, as follows:

(1) The minimum British income-tax revenue in the last 11 years was collected in 1929, when it amounted to $1,436,000,000; the maximum revenue was collected in 1923, when it amounted to $1,936,000,000. Thus, the maximum annual revenue from income tax was only 35 percent above the minimum revenue.

(2) The minimum Federal income-tax revenue in the last 11 years was collected in 1933, when it amounted to $747,000,000; the maximum revenue was collected in 1924, when it amounted to $2,842,000,000. Thus, the maximum annual revenue from income tax was 280 percent above the minimum revenue.

(3) The average annual British revenue from income tax in the 11-year period 1923 to 1933, inclusive, was $1,621,000,000. The maximum annual revenue during this period was 19 percent above this average, and the minimum 11 percent below it.

(4) The average annual Federal revenue from income tax in the 11-year period 1923 to 1933, inclusive, was $1,915,000,000. The maximum annual revenue during this period was 48 percent above this average, and the minimum was 61 percent below it.

While this stability of the English revenue is not entirely due to their treatment of capital gains and losses, it is a very important factor in producing this condition. It is easy to show that much of the instability of the Federal income-tax revenue is due to our system of taxing these gains and losses. For instance, let us analyze the individual income-tax returns for the calendar year 1928, a prosperous year; and for 1931, a year of depression:

Individual returns, 1928

Revenue:		
Capital gains (from sale of assets held over 2 years)	$1,879,780,038	
Tax		$234,972,505
Other gains (from sale of assets held 2 years or less)	2,928,141,616	
Estimated tax		322,000,000
Total revenue		556,972,505
Reduction in revenue:		
Capital losses (from sale of assets held over 2 years)	41,011,320	
Tax reduction		5,126,415
Other losses (from sale of assets held 2 years or less)	171,743,165	
Estimated tax reduction		17,100,000
Total reduction in revenue		22,226,415
Net gain in revenue (revenues less reduction in revenue)		534,746,090
Total revenue, 1928 individual returns		1,164,254,037
Percent of total revenue from gains tax		46

Individual returns, 1931

Revenue:		
Capital gains (from sale of assets held over 2 years)	$166,131,451	
Tax		$20,766,431
Other gains (from sale of assets held 2 years or less)	283,276,380	
Estimated tax		31,200,000
Total revenue		51,966,431
Reduction in revenue:		
Capital losses (from sale of assets held over 2 years)	190,607,424	
Tax reduction		23,825,928
Other losses (from sale of assets held 2 years or less)	1,043,625,622	
Estimated tax reduction		114,400,000
Total reduction in revenue		138,225,928
Net loss in revenue (reduction in revenue less revenue)		86,259,928
Total revenue 1931 individual returns		241,282,875
Percent reduction in revenue by treatment of gains and losses		26

From the above it can be seen that our revenue in a good year may be increased 46 percent and in a bad year decrease 26 percent by our system of taxing gains and crediting losses from the sale of capital assets in the case of individuals alone.

In the case of corporations a similar condition exists which also tends to instability. The figures for the gains and losses which are available in the case of corporations are as follows:

	Gains from sales of capital assets	Losses from sales of capital assets
1929	$1,315,394,560	(1)
1930	645,816,417	$935,749,879

[1] Not available.

To complete the statistical picture of gains and losses realized from the sale of assets by individuals, such gains and losses will be shown for the period 1917 to 1931, inclusive, in the following table:

Year	Profits	Losses
1917	$318,170,617	$110,720,384
1918	291,185,704	571,468,120
1919	999,364,287	1,175,140,997
1920	1,020,542,719	1,680,304,149
1921	462,858,673	1,832,641,653
1922	991,351,580	1,251,989,891
1923	1,172,154,628	1,619,082,743
Subtotal—High tax years	5,255,628,208	8,241,347,937
1924	1,513,714,092	896,906,462
1925	2,932,228,840	655,078,024
1926	2,378,542,908	212,789,639
1927	2,894,582,036	276,100,309
1928	4,807,921,654	212,754,485
1929	4,684,560,175	1,038,971,413
Subtotal—Prosperous years	19,211,549,705	3,292,600,332
1930	1,193,130,398	1,313,671,526
1931	449,407,831	1,234,233,046
Subtotal—Depression years	1,642,538,229	2,547,904,572
Grand total	26,109,716,142	14,081,852,841

In view of the above figures, the following observations may be made:

First. During the high-tax period, 1917 to 1923 inclusive, losses exceeded gains by approximately 3 billion dollars.

Second. During the prosperous and low-tax years, 1924 to 1929 inclusive, gains exceeded losses by approximately 16 billion dollars.

Third. During the depression years, 1930 and 1931, losses exceeded gains by approximately 1 billion dollars.

It seems perfectly fair to conclude, therefore, that our system of treating gains and losses for tax purposes results in an unstable revenue; it greatly reduces our revenue in war years and years of depression, and greatly increases our revenue in prosperous years. This result is unfortunate, for our revenue is reduced during those periods when we are most in need of revenue and increased when additional revenue is not required.

It is true that in the Revenue Act of 1932 and in the National Industrial Recovery Act certain changes were made in our law for the purpose of reducing the effect of losses on ordinary income subject to tax. Unfortunately, no data are yet available as to the effect of these measures.

The history of our taxation of gains and losses from the sale of assets of a capital nature (not including stock in trade) is, briefly, as follows:

Under the Revenue Act of 1913, all gains from the sale of such assets were subject to income tax. Losses from such sales were not allowed.

Under the Revenue Acts of 1916 and 1917, gains from such sales were subject to income tax. Losses from such sales were allowed only to the extent of the gains arising from such sales.

Under the Revenue Act of 1918, gains from such sales were subject to income tax and losses were allowed in full against income of any kind.

Under the Revenue Act of 1921 (as applicable to 1922 and 1923), a new treatment of these gains was devised. Gains from the sales of real estate, stocks, bonds, etc. were divided into two groups, the first consisting of those where the asset had been held for more than 2 years, and the second where the asset had been held for 2 years or less. The first group was called "capital assets" and the gains arising therefrom "capital gains." It was provided that the taxpayer would not be required to pay on these "capital gains" a tax of more than 12½ percent. This was a considerable relief from taxation, for in these years the surtax rates reached 50 percent. In the case of the second group, gains and losses arising in transactions of 2 years or less, the treatment was as in the 1918 act, that is, gains were taxed in full and losses allowed in full. A "capital net loss" was also allowed in full in spite of the fact that a capital net gain was not taxed at a rate of more than 12½ percent.

Under the Revenue Acts of 1924, 1926, and 1928, the system remained the same, except that the inconsistency in regard to the treatment of "capital net losses" was cured. These acts provide that in the case of such losses (arising in transactions covering more than two years) the reduction in tax must not exceed 12½ percent of the amount of the capital net loss.

The Revenue Act of 1932 was enacted during a period of depression when the need for revenue was acute. It was known that the revenue from the income tax had greatly declined and a part of this decline was correctly ascribed to the wiping out of ordinary income by the deduction therefrom of both classes of losses previously described. The Congress therefore provided that the losses from sales of stocks and bonds held two years or less could only be taken to the extent of the gains from similar sales. This prevented the reduction of ordinary net income from other sources by these losses. However, it was provided that losses disallowed in one year (to an amount not in excess of the net income) could be carried over and applied against short-term gains in the subsequent year. As far as "capital gains and losses" were concerned, these were treated in the 1932 act exactly as in the preceding acts of 1924, 1926, and 1928.

The National Industrial Recovery Act merely took away the right of carrying over disallowed short-term losses to the subsequent year.

A careful study of the effect of the Revenue Acts of 1913 to 1928, inclusive, has been made. The data are not yet available for an accurate study of the effect of the Revenue Act of 1932. From a study of the acts prior to 1932, the conclusion has been definitely arrived at that normal business transactions in respect to the sales of real estate, stocks, bonds, etc., will not occur under high surtaxes and that it is to the advantage of the Government from a revenue standpoint to give some relief on long-term gains. It has not been proven, of course, that our present system is the best obtainable.

The main questions are now confronted. Should we retain our present system? Should we modify it? Should we adopt the English system?

First, what are the defects of our present system? These defects seem to be as follows:

(1) It produces an unstable revenue—large receipts in prosperous years, low receipts in war and depression years.

(2) In many instances, our tax reaches the mere increase in monetary value resulting from the depreciation of the dollar instead of reaching a real increase in value.

(3) Taxpayers take their losses within the 2-year period and get full benefit therefrom, and delay taking gains until the 2-year period has expired thereby reducing their taxes.

(4) The relief afforded in the case of long-term gains (capital gains) is inequitable. It only gives relief to taxpayers with net income of over $16,000.

(5) Our system is unfair in that it taxes short-term gains in full but does not allow short-term losses except to the extent of such gain.

(6) In some instances, normal business transactions are still prevented on account of the tax.

On the other hand, what would be the probable defects of the English system if applied in this country under conditions as they exist here and in respect to the other provisions of our income tax law? These probable defects appears to be as follows:

(1) A somewhat less revenue over a long period of years.

(2) Opportunity for tax evasion through the conversion of income into gains from the sale of assets.

(3) Escape from taxation of mere speculative stock market gains which are perhaps more able to bear tax than almost any other type of income.

(4) Accumulation of wealth would be somewhat easier.

(5) The present moment is not an advantageous time, for the Government, in which to make the change to the British system, if we are at the bottom of price levels.

If we balance these defects of our own system and the probable defects in the British system if applied in this country, there appears to be little choice. It is true, however, that both of these systems might be perfected. Therefore, this office is proposing for consideration a plan which takes a middle ground between the two systems and, it is hoped, eliminates in part some of the defects of both. This plan is as follows:

(1) Put all gains and losses from the sale of the property of the taxpayer (whether or not connected with his trade or business, but not including stock in trade, or property properly included in inventory, or held primarily for sale to the customers of the taxpayer in his trade or business), into one group.

(2) Compute the "capital net gain", if any, from this group of transactions by computing the excess of the sum of the "capital gains" over the sum of the "capital losses", after multiplying each "capital gain" or "capital loss" by—

100 percent if the capital asset has been held for not more than 1 year;
80 percent if the capital asset has been held for more than 1 year but not more than 2 years;
60 percent if the capital asset has been held for more than 2 years but not more than 3 years;
40 percent if the capital asset has been held for more than 3 years but not more than 5 years;
20 percent if the capital asset has been held for more than 5 years.

(3) Include in gross income subject to tax the "capital net gain", if any, as computed in (2) above. If there is a "capital net loss", it is not to be deducted from gross income.

How this plan will minimize the defects of our present system may be indicated as follows:

(1) The first defect in our present system, already noted, was instability of revenue. The proposed plan will give somewhat less receipts in prosperous years, but substantially greater receipts in depression years. Thus, greater stability will be obtained.

(2) The second defect was the tax on the mere increase in monetary value resulting from the depreciation of the dollar. This defect while not removed will be minimized by the lower tax.

(3) The third defect was the opportunity afforded by our present system for taxpayers to realize their losses within the 2-year period and their gains outside the 2-year limit. This will be largely eliminated by the graduated scale extending over a longer period of years.

(4) The present system is defective in that it is inequitable, giving no relief to the small taxpayers and very large relief to the wealthy taxpayers. This defect is completely cured in the proposed system, all taxpayers being given equal treatment.

(5) The proposed system is somewhat more fair than the present system. All short or long term losses can be charged off against short or long term gains. At present a short term loss can not be charged off against a long term gain.

(6) Normal business transactions should be somewhat encouraged rather than discouraged by the proposed plan.

The defects that would probably be found in the British system if applied to our country seem also to be largely avoided by the proposed plan, as follows:

(1) The revenue would be greater in good years and not less in bad years under our proposed plan than it would be under the British system.

(2) Opportunity for tax evasion feared under the British plan is reduced to a minimum.

(3) Mere speculative profits (less than 1 year transactions) would be subjected to tax in full.

(4) Accumulation of wealth would be retarded more under the proposed plan than under the British plan.

(5) The present year is not an unfavorable time in which to put the proposed system in effect, as many losses have not yet been realized.

In conclusion, then, what are the main advantages that can be secured from the method proposed? It would seem, first, that greater stability would be secured; second, that all taxpayers would be treated alike; third, that normal business transactions would not be discouraged; and, fourth, that no substantial loss in revenue even over a long period of years would be incurred. Finally, the proposed method is based on the following principle:

"The tax on the capital gain should approximate the tax which would have been paid if the gain had been realized in equal annual amounts over the period for which the asset was held."

In view of our graduated rate structure, it is believed this principle is sound. To tax in 1 year at high surtax rates the entire capital gain which has accrued over a long period of years seems obviously unfair.

The method here proposed is designed especially for individuals. However, it is recommended that consideration be given to applying the same method to corporations in case tax-free reorganizations are eliminated. Such a plan would permit corporate reorganizations with the payment of a tax considerably reduced below the standard rate. A moderate tax now is, perhaps, better than a higher tax "x" years from now.

Respectfully submitted.

L. H. Parker,
Chief of Staff.

Exhibit D

Memorandum on Exchanges and Reorganizations

Under the Revenue Acts of 1913, 1916, and 1917, Congress taxed all gains from transactions involving exchanges or reorganizations in the year in which such gains were realized. The Supreme Court in a number of cases arising under those acts held that gain was realized in fact in the year in which the exchange or reorganization took place. This was true, although the taxpayer did not receive actual cash but stock or securities, which the court regarded as the equivalent of cash. However, serious opposition to taxing gains of this character developed. It was claimed that such gains were mere "paper profits", i.e., the taxpayer had realized nothing tangible and to tax them seriously interefered with normal business adjustments.

The Revenue Act of 1918 continued the policy adopted in the prior income tax laws of taxing gains when realized, with the one exception of an exchange of stock for stock (in connection with the reorganization, merger, or consolidation of a corporation) when the stock or securities received had no greater aggregate par or face value than the stock exchanged. The history of the act discloses that the House defeated a Senate amendment designed to extend this privilege to other types of transactions.

The first serious change in this policy occurred in the Revenue Act of 1921. That act exempted from immediate tax exchanges of investment and business property for property of like kind and exchanges of stock or securities in connection with corporate reorganizations. It was soon found that these provisions left the door wide open for various devices to avoid tax. Most important of these devices was one whereby property could be transferred to a corporation and its cost to the corporation determined by the fair market value of the property at the time of the transfer. The corporation would then use such enhanced value in computing its gain from a subsequent sale. Moreover, the exchange provisions permitted a tax-free exchange of stock or securities not connected with a reorganization. Many brokers, investment houses, and bond houses established exchange departments and advertised to their customers that they could exchange securities in such a manner as to result in no taxable gain. The situation became so serious that Congress in 1923 was forced to pass a special act removing the exemption in the case of stock or securities exchanged otherwise than through a corporate reorganization.

The Revenue Act of 1924 is the nucleus about which the present provisions were built. While the later acts have made certain changes in these provisions, such changes were designed to plug up some of the more obvious loopholes without attempting to make any change in principle. All of the reorganizations which the Supreme Court held to result in taxable income under the Revenue Act of 1917 and prior acts are now made tax free under the present law.

The exchange and reorganization provisions of the present law will now be briefly discussed. Under section 112 of the Revenue Act of 1932, gain or loss is recognized upon the sale or exchange of property with certain specified excep-

tions. These exceptions provide that no gain or loss shall be realized in the following cases:

(1) If investment property or property used in a trade or business is exchanged for property of a like kind. This rule does not apply to stock in trade, property held primarily for sale, or stocks or bonds.

(2) If common stock in a corporation is exchanged solely for common stock in the same corporation;

(3) If preferred stock in a corporation is exchanged solely for preferred stock in the same corporation;

(4) If stock or securities are exchanged solely for other stock or securities in a corporate reorganization;

(5) If property is exchanged by a corporation for stock or securities in another corporation pursuant to a corporate reorganization;

(6) If property is transferred to a corporation by one or more persons and immediately after the transfer such person or persons are in control of the corporation.

Furthermore, if stock or securities are distributed to a shareholder upon reorganization of a corporation without surrender of his stock or securities, no gain is recognized to the shareholder from such receipt. Moreover, if in any of the above transactions the taxpayer receives money or other property in addition to the property specified and there is in fact a gain from the exchange or reorganization, such gain is recognized at that time to the extent of the other property or money received. However, this last rule does not apply to a corporation if the corporation distributes such money or other property to its stockholders.

In support of the theory that the above provisions do not result in tax exemption but merely in tax postponement, the law contains other provisions designed to prevent the taxpayer from stepping up his original cost when he sells the property received in exchange for the old property. The general theory is that the property received in exchange takes the place of the old property. In the case of property transferred to a corporation, the law also requires the corporation to use as its basis the cost of the property to the transferor, if after the transfer such transferor controls a majority interest in the corporation.

The underlying principle behind all of the exchange and reorganization provisions of the present law is that they do not result in tax exemption, but that the tax is postponed until a gain is realized from a pure sale or what amounts to a pure sale. The reasons assigned for such a policy are—

(1) That such provisions prevent much of the uncertainty and litigation which was involved in the prior income-tax laws;

(2) Normal business adjustments will not be interfered with if so-called "paper profits" are exempted;

(3) The revenues of the Government will be increased by preventing taxpayers from taking colorable losses.

The Bureau has now had an experience of more than a decade in the administration of these provisions. This experience shows that the abuses under the present policy far outweigh the advantages. In the first place, the provisions of the present law are very involved, difficult to understand, and particularly hard to interpret in the light of actual cases as they arise. The interpretation placed upon these provisions by the Treasury has been overturned by the courts in many cases, so that at present there is a great deal of confusion and uncertainty.

In the second place, the administrative problems in ascertaining the value of property made necessary under the prior acts have not been greatly reduced by the provisions of the law, for where money or other property is received in addition to stock or securities, it is necessary to value the stock or securities in order to determine whether an actual gain has been realized. In many corporate reorganizations, while cash is not involved, the acquiring corporation generally assumes some of the indebtedness of the old corporation, which indebtedness is regarded as the equivalent of cash.

The second reason assigned for the change in policy appears to have been based upon the complaint that taxing the gain when realized seriously interfered with normal business readjustments. The very high tax rates of the 1917 and 1918 acts, it was claimed, imposed upon the taxpayer the burden of having available substantial cash at a time when the transaction resulted in a mere "paper profit." While this claim undoubtedly has some merit, it is believed

that the present provisions have been utilized for other purposes of an indefensible character. Many reorganizations have been undertaken for the purpose of avoiding taxes. Furthermore, the present provisions have encouraged the injection into business structure of an unsavory stimulas, such as the organization of large holding companies and the overcapitalization of business.

The third reason assigned was that these provisions would prevent the taking of heavy losses, thereby resulting in an increase in the revenues of the Government. While these provisions may have rendered it more difficult for taxpayers to take losses, it by no means closed the door. The taxpayer upon "legal advice" prior to the arrangement of the terms of the transaction may still take substantial losses in most instances without actual interference with his original plan and purpose.

The statute provides that upon the sale or exchange of property the entire amount of gain or loss shall be recognized, with certain exceptions. The exceptions are the exchange and reorganization provisions already referred to. If a taxpayer desires to take a loss, it is easy to arrange a transaction falling without the exceptions. On the other hand, if it is desired to pay no tax on the gain, the transaction can be so arranged as to come within the exceptions. In addition, losses from the sale or exchange of stocks and bonds are limited, to a large extent, to the gains from such sales or exchanges, so in many cases a stock or bond loss even if recognized could not be utilized by the taxpayer.

Instead of increasing the Government revenues, these provisions appear to result in a considerable loss of revenue. The theory of postponing the gain by shifting the original cost basis of the transferor over to the transferee or by requiring the transferor to keep his original cost basis for the property he receives in exchange does not compensate the Government for exempting the prior transaction from tax. This is due to the fact that in the year which the taxpayer chooses to realize the gain he may have heavy losses, or the tax rates may be different. Death and other elements may also enter in to create a new cost basis for the property.

One of the main objections to the reorganization provisions is that the recognition of gain depends more upon the form of the transaction than upon the essential facts, undue importance being given to "expert advice." Therefore, in practice, the sections sometimes result in double taxes and sometimes in complete tax exemption. In many cases the shifting of the cost basis of property over to a transferee corporation frequently causes the tax burden to fall upon the backs of new stockholders, who have paid full market value for their stock.

The following examples show how the provisions of the present law are availed of to avoid taxes justly due the Government:

CASE NO. 1

A owns a piece of undeveloped real property which cost him $100,000, but from which he is receiving no income. This property is now worth $600,000. He exchanges it for improved business property worth $600,000. Under the exchange provisions of existing law, A realizes no gain from this exchange. Under the Revenue Act of 1913 and prior acts, he would have been taxable on a gain of $500,000. It is claimed that under existing law, A, by being required to retain his original cost of $100,000 for the improved property, does not escape tax on the $500,000 gain but that payment of such tax is postponed until such time as A sells the improved city property. However, this is not true. There are many ways in which A, under existing law, may escape the payment of any tax whatever on this gain or may materially reduce the amount of such tax. The following are some of the methods by which A may secure complete or partial tax avoidance with respect to this gain:

(1) He may elect to realize a gain in a year in which it is convenient to take substantial losses from other transactions, thereby materially reducing his tax or escaping tax altogether.

(2) If A had been taxed on the gain at the time of the exchange, he would have been subject to the full surtax rate if the undeveloped real property was acquired within 2 years prior to the exchange. By the exchange provisions, he is enabled to convert such ordinary gain into a capital gain by holding the improved property for a period of 2 years computed from the time he acquired the unimproved property.

(3) If A dies before he sells the improved property, its cost basis is changed from the $100,000 cost of the original property to the value of such improved property at the time of his death. Thus, if the value of the improved property at the time of death is worth $600,000, and the executor or beneficiaries of A's estate sold the property, the Government would collect no income tax whatever on the transaction. Moreover, if the value at the date of death was $800,000 and the executor or beneficiaries sold the property for $600,000, there would be a deductible loss of $200,000.

(4) From a practical standpoint, the exchange and reorganization provisions lead to tax avoidance, due to the difficulty of the persons administering the law in tracing the property through a series of exchanges and reorganizations.

CASE NO. 2

A owns a piece of undeveloped real property which cost him $100,000, but from which he is receiving no income. This property is now worth $600,000. He exchanges it for improved business property worth $400,000 and cash amounting to $200,000. The total gain realized by A from this transaction is $500,000 Under the exchange provisions of the present law he would only be taxed upon an immediate gain of $200,000. The theory is that the balance of the gain, namely, $300,000, is postponed until A sells the improved business property. However, for the same reasons set out in case no. 1, A may never pay any tax on this $300,000, or may materially reduce the amount of this tax.

CASE NO. 3

Corporation A has a capital of $1,000,000 and $100,000 surplus. It desires to distribute this surplus to its stockholders without subjecting the stockholders to any income tax on this distribution. It organizes corporation B, to which it transfers this $100,000 surplus in exchange for all of the stock of corporation B. This is a reorganization under the present law. Corporation A can then distribute the stock of corporation B to its stockholders and the stockholders will not be subject to any tax upon the receipt of B's stock (because this is a distribution of stock acquired under a plan of reorganization and is exempt from tax by section 112(g) of the Revenue Act of 1932).

Under the Revenue Act of 1918 and prior acts the distribution of the stock of B to A's stockholders would constitute a dividend to them and they would pay a tax accordingly.

CASE NO. 4

Corporation A owns all the stock of corporation B. Corporation B has a surplus of $1,000,000, and included among its assets are distillers' warehouse receipts which cost it $100,000, but which are now worth $500,000. It is desired to sell these warehouse receipts without the payment of any tax. This can be done in the following manner:

Corporation B distributes the warehouse receipts to corporation A by declaring a dividend in kind. This being a dividend from one corporation to another corporation A pays no tax upon its receipt. The cost basis for these warehouse receipts in A's hands is now $500,000. A sells the warehouse receipts for $500,000 (its cost basis) and, therefore, pays no tax on the sale.

CASE NO. 5

A, an individual, owns certain real estate which cost him $100,000 but is now worth $1,000,000. A desires to sell this property but wishes to pay no tax on $900,000. Can A get this $1,000,000 without paying a tax? Yes; this can be accomplished through the reorganization section of the present revenue act.

A organizes corporation X and transfers the property to corporation X for all of its capital stock. There is no profit in this transfer because it is a transfer where the transferor is in control of the corporation after the transfer (sec. 112 (b) (5)). After corporation X has earned a surplus in excess of $1,000,000, A organizes corporation Y and transfers to it all the stock he owns in corporation X for its capital stock. (No gain on this transaction—sec. 122 (b) (4).)

Corporation X now transfers the property to corporation Y as a dividend in kind. No tax on this transaction. (Corporation does not pay a tax on a dividend received.) The property is now in the hands of corporation Y and the basis is the same as in the hands of the transferor corporation (corporation X), namely, $1,000,000. Corporation Y now sells the property for $1,000,000 cash, and realizes no gain because of its basis.

A being in control of corporation Y, can now control the disposition of this money, i.e., he can invest it, or borrow it, thus obtaining the use of the $900,000 gain without paying a tax.

CASE NO. 6

Corporation X has a capital of $1,000,000 (10,000 shares, par value $100) and a surplus of $500,000. It desires to distribute this surplus to its stockholders without subjecting it to any tax. To accomplish this, corporation Y is organized and corporation X transfers the surplus of $500,000 to corporation Y in exchange for all of Y corporation's stock. This is a tax-free reorganization under the present law and no gain is recognized to corporation X or Y from this exchange (sec. 112(b) (4) (i) (1) (B), Revenue Act of 1932). Corporation X then distributes Y corporation's stock to its stockholders without the surrender of their stock, each stockholder receiving the same number of shares of stock in corporation Y which he has in corporation X. X corporation's stockholders are not taxed upon the receipt of Y stock (sec. 112(g), Revenue Act of 1932). X corporation's stockholders then liquidate corporation Y. By this method they acquire the $500,000 surplus. A is the owner of 1,000 shares of corporation X for which he paid par ($100 per share, or) $100,000. As a result of the reorganization, he receives 1,000 shares of corporation Y. The basis of Y's stock is $50 a share, or $50,000. Since a liquidating dividend is treated as a sale of the stock, A is only required to pay a tax on the excess of the liquidating dividend over his basis for Y's stock. Since the liquidating dividend does not exceed his basis for Y stock, he pays no tax whatever.

CASE NO. 7

A owns all the capital stock in corporation no. 1. Corporation no. 1 owns 1,000 shares of corporation no. 2. A desires to obtain these shares of corporation no. 2, so he can sell them, thereby obtaining money, but he does not want them declared to him as a dividend by corporation no. 1, as such dividend would be subject to surtax, but he is willing to pay a tax computed under the capital gain provision of the revenue act. Can he do this? Yes, it can be accomplished by means of the reorganization provision of the revenue act.

Corporation no. 3 is organized. Corporation no. 1 transfers to corporation no. 3 the 1,000 shares of corporation no. 2, in consideration of which corporation no. 3 transfers all of its capital stock to A. Corporation no. 3 then liquidates and distributes its assets to A. A then sells the 1,000 shares of stock of corporation no. 2.

The Board of Tax Appeals held in *Gregory* v. *Commissioner* (P.H. 1933, par. 386) that the liquidation of corporation no. 3, whereby A received the stock of corporation no. 2, resulted in a capital gain, the difference of the basis attributable to corporation no. 3 stock and the value of corporation no. 2 stock so received. The subsequent sale of corporation no. 2 stock for no more than the value at the time of the liquidation resulted in no further gain.

CASE NO. 8

Corporation no. 1 owns a minority interest in corporations no. 3 and no. 4. Corporation no. 2 likewise owns a minority interest in corporations no. 3 and no. 4. Corporation no. 1 desires to get control of corporations no. 3 and no. 4. Corporation no. 2 is willing to sell its interest in corporations no. 3 and no. 4, but does not want to pay a tax on any gain it might derive from a sale of its holding in corporations no. 3 and no. 4. Can this be done? Yes, it can be accomplished by means of the reorganization provision of the revenue act.

Corporation no. 2 forms corporation no. 5, and transfers its holdings in corporations no. 3 and no. 4 to it in exchange of the capital stock of corporation no. 5. Corporation no. 3 then transfers its holding of corporation no. 5's stock in corporation no. 1. In a few days corporations no. 1 and no. 5 are merged and no. 1 becomes the owner of the stock of no. 3 and no. 4 which was formerly owned by no. 2.

In view of the matter already presented, the following suggestions are made:

(1) To abolish the exchange and reorganization provisions of the present law.

(2) To eliminate all of the exchange and reorganization provisions of the present law, except those permitting an individual to incorporate his business without being subject to tax.

(3) To require gain to be realized and the tax determined at the time of the exchange or reorganization under plan (1) or plan (2), but not to enforce payment of the tax for a period (A) within 2 years from the date the tax is due, or (B) within 6 months after the property is received is sold, whichever date is the earlier. Under this plan, the Government should be protected by the giving of the proper bond and the suspension of the statute of limitations during this period. In any case where cash is received at the time of the exchange, it is believed that the tax should be paid immediately up to the extent of the cash received.

Under all of the above plans, provision should be made for continuing the basis provisions of existing law with respect to property acquired pursuant to an exchange or reorganization consummated prior to the enactment of the proposed act. This will prevent a taxpayer who has acquired property in a tax-free exchange or reorganization from avoiding tax by getting a stepped-up basis.

This memorandum has been prepared by Mr. Colin F. Stam, counsel, and Mr. G. D. Chesteen, corporation auditor, of the staff of the Joint Committee on Internal Revenue Taxation. It meets with the approval of the undersigned.

Respectfully submitted.

L. H. Parker, *Chief of Staff.*

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END OF
TITLE